

CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION FINAL ACTION SUMMARY

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3 In the Matter of the Petition for Redetermination)
4 Under the Sales and Use Tax Law of:)
5 EAST COAST FOODS, INC., dba) Account Number: SR Y AS 11-668284
6 Roscoe's House of Chicken N' Waffles) Case ID 444779
7 Petitioner) Los Angeles, Los Angeles County

8 Type of Business: Restaurants
9 Audit period: 07/01/01 – 06/30/05

<u>Item</u>	<u>Disputed Amount</u>
10 Unreported taxable sales	\$16,419,143
11 Penalties	\$ 233,624
12 Tax as determined and protested	\$1,349,989.74
13 Interest through 02/28/13	1,043,544.02
Negligence penalty	134,999.02
14 Amnesty-double negligence penalty	46,060.60
Amnesty interest penalty	<u>52,564.30</u>
15 Total tax, interest, and penalty	\$2,627,157.68
16 Payments	- 3,263.52
Balance Due	<u>\$2,623,894.16</u>
17 Monthly interest beginning 03/01/13	<u>\$ 6,733.63</u>

18 This is an appeal that is covered by Revenue and Taxation Code section (Section) 40.

19 Therefore, after the Board has made a determination in this matter, a written opinion that, among other
20 things, sets forth the relevant factual findings and the legal analysis on which that determination is
21 based must be published on the Board's website within 120 days from the date the Board renders a
22 final decision in this matter. Accordingly, the Board may wish to consider the following two options:

23 (A) The Board could follow its usual practice in business tax appeals, in which it typically
24 votes to resolve the appeal on the day on which the nonappearance matter is scheduled. Under
25 the usual practice, a notice of the Board's determination will be mailed within 45 days of the
26 date of the Board's vote, and the 30-day period for the filing of a Petition for Rehearing (PFR)
27 would begin on the date the notice is mailed. If a PFR is not filed, the Board's determination
28 will become final and its decision will be rendered at the expiration of the 30-day PFR period.
Unless the Board specifically directs that it desires to issue a precedential (Memorandum
Opinion) decision in this matter, staff would then expeditiously bring back a proposed
(nonprecedential) Summary Decision that complies with Section 40 for the Board's approval
on a later calendar. The adopted decision will be published timely on the Board's website. If a

1 PFR is filed, no decision will be rendered until the conclusion of the petition for rehearing
2 process.

3 (B) The Board could inform staff of its tentative determination and direct staff to prepare a
4 proposed Summary Decision (or Memorandum Opinion) that reflects the tentative
5 determination for Board approval as soon as practicable. Under this option, the Board would
6 hold any determination of the appeal in abeyance until it has the opportunity to consider the
7 proposed decision. The Board's later vote to adopt the decision would also constitute its vote
8 to resolve the appeal, and within 45 days a notice of decision would be mailed. The 30-day
9 PFR period would begin running when the notice of the Board's determination was mailed. If
10 no PFR is filed, the Summary Decision (or Memorandum Opinion) would then be timely
11 posted on the Board's website pursuant to Section 40.

12 The Board held a hearing regarding this matter on April 26, 2012, and returned the case to the
13 Sales and Use Tax Department (Department) to conduct a reaudit with the admonition to petitioner that
14 it needed to cooperate with the Department in that reaudit. The reaudit was scheduled for
15 consideration on the Adjudicatory Calendar for the Board's December 2012 meeting in Sacramento,
16 but was postponed to the meeting in Culver City at petitioner's request, to afford it an opportunity to
17 make a public comment at the meeting.

18 Based on petitioner's submissions and the Department's response, we do not recommend
19 adjustments, as discussed below under Post Hearing Developments.

20 UNRESOLVED ISSUES

21 **Issue 1:** Whether adjustments are warranted to the amount of unreported taxable sales. We
22 find no adjustments are warranted.

23 Petitioner operates four restaurants specializing in sales of chicken and waffles. The only
24 records petitioner provided for audit were federal income tax returns for 2001, 2002, and 2003, menus,
25 and bank statements. The Department established audited sales on a markup basis. Since petitioner
26 provided no purchase records and most of petitioner's menu items included chicken, the Department
27 first established the audited amount of taxable sales of meals including chicken by using information
28 regarding the costs of individual chicken pieces, obtained from Foster Farms, and the prices of meals
on petitioner's menus. After petitioner objected to the computed markup, the Department conducted a
test, along with a representative of petitioner, to establish the weighting of various meals, which
resulted in an increase of the audited markup from 774.39 percent to 804.32 percent for menu items

1 containing chicken.¹ To establish the audited cost of chicken sold, the Department reduced purchases
2 of chicken by 12 percent for self-consumption and by 5 percent for losses due to theft, contamination
3 of food, and spoilage. The Department used the audited markup and the audited cost of chicken sold to
4 establish audited taxable sales of menu items including chicken of \$15,664,179 for 2002 and 2003.
5 The Department then deducted the purchases of chicken from the purchases reported on the federal
6 returns, and it reduced that figure by 3 percent for shrinkage to establish the audited cost of sales of
7 beverages and food items other than chicken. The Department recognized that the majority of the food
8 items were sold with chicken meals, and those sales were already included in the \$15,664,179. The
9 Department estimated that 30 percent of the audited cost of sales of beverages and food items other
10 than chicken represented costs of items that were not components of chicken meals. It therefore
11 applied 30 percent to the audited cost of those items and used that figure, along with an estimated
12 markup of 325 percent, to compute audited sales of beverages and food sold without chicken of
13 \$5,495,713.

14 The Department compared the total audited taxable sales of \$21,159,892 (\$15,664,179 +
15 \$5,495,713) to reported taxable sales of \$12,656,731 for 2002 and 2003 to compute a percentage of
16 error of 67.18 percent, which it applied to reported taxable sales for the audit period to establish an
17 understatement of \$16,939,040. It deducted the sales of \$519,897 petitioner reported on amnesty tax
18 returns and issued a determination based on an understatement of \$16,419,143.

19 Petitioner contends that its reported taxable sales are accurate and asserts that they are
20 supported by the amounts of bank deposits. Accordingly, petitioner asserts that the audit should be
21 based on an analysis of bank statements. Alternatively, if taxable sales are established on a markup
22 basis, petitioner asserts that the purchases of chicken should be adjusted for allowances totaling
23 42 percent rather than the 17 percent allowed by the Department. As support, petitioner provided
24 photographs and Internet articles. In response to the Department's observation that petitioner must
25 have taken steps to minimize waste, petitioner responded that chicken is so inexpensive that changes in
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27 ¹ Since the markup was based solely on the cost of the chicken and applied solely to the cost of chicken, it is a higher
28 percentage than would have been the case if it had been based on the cost of all items sold as part of the meals and applied
to the cost of all such items.

1 procedures to reduce waste are not warranted. Petitioner also suggested that it would like to have the
2 Department observe the restaurant, focusing on the amount of chicken dropped or otherwise
3 contaminated and the number of extra pieces of chicken provided at no extra charge. Further,
4 petitioner argues that the audited sales represent a number of sales that was physically impossible.

5 With respect to the audited cost of goods sold, we note the Department has made allowances
6 for losses and for self-consumption well in excess of the allowances established in the audit manual,
7 and petitioner has not provided evidence to support its estimate that 42 percent of the chicken
8 purchased is not sold. We find the observation test petitioner suggests would not provide reliable
9 evidence because it could easily be manipulated to petitioner's advantage. We are not persuaded by
10 petitioner's assertion that chicken is so inexpensive that there is no incentive to minimize waste or by
11 petitioner's unsupported statement that 10 percent of the chicken purchased is used to provide extra
12 pieces with chicken meals. In short, in the absence of clear, objective documentation, we find no
13 increases to the allowances for shrinkage, spoilage, or self-consumption are warranted. Also, we reject
14 petitioner's assertion that the audited amount of sales represents a number of sales that is physically
15 impossible. With respect to petitioner's contention that the audited sales should be based on an
16 analysis of bank deposits, we recommended in the D&R that a reaudit be conducted to establish
17 audited sales using an analysis of credit card deposits, if petitioner provided specific documentation for
18 review. Although the Department gave petitioner two opportunities to provide the requisite records,
19 petitioner presented nothing. Accordingly, we find no adjustment is warranted.

20 **Issue 2:** Whether petitioner was negligent. We conclude that it was.

21 The Department originally recommended a fraud penalty because of petitioner's failure to
22 provide records and the substantial understatement. The Department noted that petitioner had been
23 audited previously and should have been aware of the requirement to maintain books and records and
24 provide them for examination. However, in light of petitioner's explanation that its records had been
25 lost due to theft and damage from severe inclement weather, the Department instead imposed the
26 negligence penalty. Petitioner disputes the negligence penalty on the basis that it did provide records,
27 as well as various economic analyses. Petitioner also argues that the audit would not show a
28 substantial understatement if it had been conducted correctly.

1 numerous contacts with petitioner's representative regarding the records needed to consider
2 adjustments to the audit, and the Department ultimately allowed the representative until October 26,
3 2012, to provide records, but it received nothing.

4 Then, on November 14, 2012, the Department received documentation via Fed Ex which
5 included copies of merchant bank statements for two accounts at two different banks, along with
6 "Merchant Account Sampling Summaries" for the years 2001 through 2005 that had been prepared by
7 petitioner's representative. The Department found that the documentation was comprised of estimated
8 amounts of credit card receipts for the four restaurant locations, computed using sporadic monthly
9 credit card deposits primarily from one of the four restaurant locations, and an estimated ratio of cash
10 to total sales of 46 percent, computed from "all available sources," an unidentified term used by the
11 representative. As the Department explained to petitioner, in order for audited sales computed using
12 an analysis of the ratio of credit card to total sales to be accurate, the total credit card deposits must be
13 known, which requires complete and accurate bank records for all the business locations, for some
14 extended period of time (preferably for the entire audit period). The Department also explained that a
15 critical component of the computation is an accurate credit card to total sales ratio. Here, we have
16 neither a documented amount of credit card receipts nor a credit card ratio computed using some
17 defined, objective method. We therefore agree with the Department that the information that petitioner
18 recently provided is not reliable or sufficient.

19 Based on its November 14, 2012 submission, petitioner seeks an adjustment to taxable sales
20 which, the Department computes, would reduce audited taxable sales to an amount even less than the
21 taxable sales petitioner reported and would result in an unreasonably low markup of 67 percent (which
22 is even less than the 94 percent book markup based on petitioner's 2002 and 2003 federal returns that
23 was itself deemed far below the range of markups expected for a restaurant). In contrast, the audited
24 markup is 224 percent, which is reasonable for this business. Not only do we find the documentation
25 petitioner has provided does not support a finding that petitioner actually over-reported its tax due, we
26 further find that petitioner has provided no basis for any adjustment whatsoever. We therefore
27 continue to recommend that the petition be denied without adjustment.

28 Summary prepared by Deborah A. Cumins, Business Taxes Specialist III

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MARKUP TABLE

Percentage of taxable vs. nontaxable purchases	100%
Mark-up percentages developed	804.32%-meals with chicken 325%-beverages and items not included with chicken meals
Self-consumption of chicken allowed in dollars	About \$125,000 per year
Self-consumption of chicken allowed as a percent of total purchases	12%
Losses due to theft, contamination, and spoilage allowed in dollars	About \$52,000 per year
Losses due to theft, contamination, and spoilage allowed as a percent of total purchases	5%
Shrinkage of beverages and food items other than chicken allowed in dollars	About \$67,000 per year
Shrinkage of beverages and food items other than chicken allowed as a percentage of total purchase	3%