

**CALIFORNIA STATE BOARD OF EQUALIZATION**

**SUMMARY DECISION UNDER REVENUE AND TAXATION CODE SECTION 40**

1  
2  
3  
4 In the Matter of the Petition for Redetermination )  
Under the Sales and Use Tax Law of: )  
5 ) Account Number SR Y AS 11-668284  
EAST COAST FOODS, INC., dba ) Case ID 444779  
6 Roscoe’s House of Chicken N’ Waffles ) Oral hearing date: April 26, 2012  
7 )  
Petitioner )

8  
9 **Representing the Parties:**

10 For Petitioner: Sam L. White  
John L. Sadd, Jr.  
11 For Sales and Use Tax Department: Scott Lambert  
12 For Appeals Division: David H. Levine, Tax Counsel IV  
13

14 **LEGAL ISSUE 1**

15 Whether adjustments are warranted to the amount of unreported taxable sales.

16 **FINDINGS OF FACT AND RELATED CONTENTIONS**

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

1 774.39 percent to 804.32 percent for menu items containing chicken.<sup>1</sup> To establish the audited cost of  
2 chicken sold, the Department reduced purchases of chicken by 12 percent for self-consumption and by  
3 5 percent for losses due to theft, contamination of food, and spoilage. The Department used the  
4 audited markup and the audited cost of chicken sold to establish audited taxable sales of menu items  
5 including chicken of \$15,664,179 for 2002 and 2003. The Department then deducted the purchases of  
6 chicken from the purchases reported on the federal returns, and it reduced that figure by 3 percent for  
7 shrinkage to establish the audited cost of sales of beverages and food items other than chicken. The  
8 Department recognized that the majority of the food items were sold with chicken meals, and those  
9 sales were already included in the \$15,664,179. The Department estimated that 30 percent of the  
10 audited cost of sales of beverages and food items other than chicken represented costs of items that  
11 were not components of chicken meals. It therefore applied 30 percent to the audited cost of those  
12 items and used that figure, along with an estimated markup of 325 percent, to compute audited sales of  
13 beverages and food sold without chicken of \$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 Notice of Determination (NOD) based on an understatement of \$16,419,143.

19 Petitioner asserts that the audited taxable sales are overstated. Petitioner also contends that its  
20 reported taxable sales are accurate and asserts that they are supported by the amounts of bank deposits.  
21 Accordingly, petitioner asserts that the audit should be based on an analysis of bank statements.  
22 Alternatively, if taxable sales are established on a markup basis, petitioner asserts that the purchases of  
23 chicken should be adjusted for allowances totaling 42 percent rather than the 17 percent allowed by the  
24 Department. As support, petitioner provided photographs and Internet articles. In response to the  
25 Department's observation that petitioner must have taken steps to minimize waste, petitioner

26  
27  
28 <sup>1</sup> Since the markup was based solely on the cost of the chicken and applied solely to the cost of chicken, it is a higher 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 responded that chicken is so inexpensive that changes in procedures to reduce waste are not warranted.  
2 Petitioner also suggested that it would like to have the Department observe the restaurant, focusing on  
3 the amount of chicken dropped or otherwise contaminated and the number of extra pieces of chicken  
4 provided at no extra charge.

#### 5 APPLICABLE LAW

6 California imposes sales tax on a retailer's retail sales in this state of tangible personal property,  
7 measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from  
8 taxation by statute. (Rev. & Tax. Code, § 6051.) All of a retailer's gross receipts are presumed subject  
9 to tax, unless the retailer can prove otherwise. (Rev. & Tax. Code, § 6091.) When the Board is not  
10 satisfied with the accuracy of the tax returns filed, it may base its determination of the tax due upon the  
11 facts contained in the return or upon any information that comes within its possession. (Rev. & Tax.  
12 Code, § 6481.) It is the taxpayer's responsibility to maintain and make available for examination on  
13 request all records necessary to determine the correct tax liability, including bills, receipts, invoices, or  
14 other documents of original entry supporting the entries in the books of account. (Rev. & Tax. Code,  
15 §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698, subd. (b)(1).) Where the Board determines a  
16 deficiency, the burden of proof is on the taxpayer to explain the disparity between the taxpayer's books  
17 and records and the results of the Board's audit. (*Riley B's, Inc. v. State Board of Equalization* (1976)  
18 61 Cal.App.3d 610, 615-616.)

#### 19 ANALYSIS & DISPOSITION

20 With respect to the audited cost of goods sold, we note the Department has made allowances  
21 for losses and for self-consumption well in excess of the standard allowances established in the Sales  
22 and Use Tax Audit Manual (Audit Manual),<sup>2</sup> and petitioner has not provided evidence to support its  
23 estimate that 42 percent of the chicken purchased is not sold. The Audit Manual does not call for the  
24 kind of observation test petitioner suggests, and we find such a test unreliable because it would be  
25 based on evidence that could easily be manipulated to increase waste. We are not persuaded by  
26

---

27 <sup>2</sup> Audit Manual sections 0809.25 and 0809.30 generally provide for a standard allowance of 2 percent for self-consumption  
28 and pilferage, respectively, unless evidence supports a higher allowance.

1 petitioner's assertion that chicken is so inexpensive that there is no incentive to minimize waste or by  
2 petitioner's unsupported statement that 10 percent of the chicken purchased is used to provide extra  
3 pieces with chicken meals. In short, in the absence of credible, persuasive evidence, we find that no  
4 increases to the allowances for shrinkage, spoilage, or self-consumption are warranted.

5 Also, regarding petitioner's assertions that the audited amount of sales is overstated or that the  
6 audited sales should be based on an analysis of bank deposits, we find that the Department's  
7 determination is based on the best-available evidence, and that petitioner has failed to submit  
8 persuasive evidence sufficient to warrant any reductions to the measure of tax. Accordingly, we find  
9 no adjustment is warranted.

## 10 LEGAL ISSUE 2

11 Whether petitioner was negligent.

## 12 FINDINGS OF FACT AND RELATED CONTENTIONS

13 The Department originally recommended a fraud penalty because of petitioner's failure to  
14 provide records and the substantial understatement. The Department noted that petitioner had been  
15 audited previously and should have been aware of the requirement to maintain books and records and  
16 provide them for examination. However, in light of petitioner's explanation that its records had been  
17 lost due to theft and damage from severe inclement weather, the Department instead imposed the  
18 negligence penalty.

19 Petitioner disputes the negligence penalty on the basis that it did provide records, as well as  
20 various economic analyses. Petitioner also argues that the audit would not show a substantial  
21 understatement if it had been conducted correctly.

## 22 APPLICABLE LAW

23 Revenue and Taxation Code section 6484 provides that if any part of the deficiency for which a  
24 deficiency determination is made was due to negligence or intentional disregard of the law or  
25 authorized rules and regulations, a penalty of 10 percent of the amount of the determination must be  
26 imposed. Negligence is the failure to act with due care and to do what a reasonably prudent person  
27 would do under the same or similar circumstances. (See *Howard v. Commissioner* (9th Cir. 1991) 931  
28 F.2d 578, 581-582; Audit Manual, § 0506.10.)

1 In addition, a taxpayer is required to maintain and make available for examination on request  
2 by the Board all records necessary to determine the correct tax liability under the Sales and Use Tax  
3 Law and all records necessary for the proper completion of its sales and use tax returns. (Rev. & Tax.  
4 Code, §§ 7053, 7054; Cal. Code. Regs., tit. 18, § 1698, subd. (b)(1).) Such records include, but are not  
5 limited to: (1) the normal books of account ordinarily maintained by the average prudent  
6 businessperson engaged in the activity in question; (2) bills, receipts, invoices, cash register tapes, or  
7 other documents of original entry; and (3) schedules of working papers used in connection with the  
8 preparation of the tax returns. (Cal. Code Regs., tit. 18, § 1698, subd. (b)(1).) Failure to maintain and  
9 keep complete and accurate records is considered evidence of negligence. (Cal. Code Regs., tit. 18,  
10 § 1698, subd. (k).)

### 11 ANALYSIS & DISPOSITION

12 Petitioner provided no purchase records, guest checks, cash register tapes, or daily sales reports  
13 for the audit period, despite repeated requests for such records and ample opportunity to provide them.  
14 Petitioner failed to provide evidence to substantiate the claimed loss of records due to inclement  
15 weather or theft, and thus we decline to rely on the claim. Petitioner had been audited previously and  
16 must have realized the importance of providing appropriate records, and its failure to provide records is  
17 evidence of negligence. All of the samples, analyses, photographs, and written statements petitioner  
18 has provided are no substitute for summary records and source documents. Also, the understatement  
19 of reported taxable sales of \$16,419,143 (even after petitioner reported \$519,897 on amnesty returns)  
20 represents an understatement of 63.8 percent when compared to reported taxable sales of \$25,734,308.  
21 The amount of the understatement and the degree of error are too significant to dismiss, particularly  
22 since the sizable understatement represents amounts for which petitioner collected sales tax  
23 reimbursement. Accordingly, we conclude that petitioner was negligent and that the penalty is  
24 appropriate.

### 25 LEGAL ISSUE 3

26 Whether relief of the amnesty-related penalties is warranted.  
27  
28

1 FINDINGS OF FACT AND RELATED CONTENTIONS

2           Petitioner applied for amnesty and filed returns pursuant to the tax amnesty program for the  
3 period October 1, 2001, through September 30, 2002. (Rev. & Tax. Code, § 7073, subd. (a).)  
4 Petitioner then entered into an installment payment plan and paid the amounts reported on its amnesty  
5 returns. However, since petitioner failed to report all of the tax due for the periods eligible for  
6 amnesty, a penalty of \$46,060.60, which doubles the negligence penalty for amnesty-eligible periods  
7 pursuant to Revenue and Taxation Code, section 7073, subdivision (c), was included in the NOD  
8 issued to petitioner. Also, an amnesty-interest penalty (based on 50 percent of the accrued interest as  
9 of March 31, 2005, on the tax due as of that date for amnesty-eligible periods), in the amount of  
10 \$52,564.30, applies because of petitioner's failure to pay all of the tax and interest due for the amnesty-  
11 eligible periods by March 31, 2005. (See Rev. & Tax. Code, § 7074, subd. (a)).

12           On April 9, 2010, petitioner filed a declaration under penalty of perjury requesting relief from  
13 all penalties for the period July 1, 2001, through June 30, 2005. In the declaration, petitioner reiterates  
14 its contentions regarding errors in the audit methodology, which it claims led to unreliable audit  
15 results. Petitioner also claims that it provided voluminous records and written analyses previously and  
16 declares its willingness to provide any additional information necessary to reach a fair and proper  
17 resolution to the audit. This declaration also includes petitioner's statement that the fact that certain  
18 records were not available was out of its control, since these records were lost due to theft and severe  
19 inclement weather damage.

20 APPLICABLE LAW

21           Amnesty penalties imposed under sections 7073 and 7074 may be relieved if the Board finds  
22 that a taxpayer's failure to timely apply for amnesty or satisfy the liability was due to reasonable cause  
23 and circumstances beyond the taxpayer's control, and occurred notwithstanding the exercise of  
24 ordinary care and in the absence of willful neglect. (Rev. & Tax. Code, § 6592, subd. (a).) A taxpayer  
25 seeking relief from these penalties must submit a statement under penalty of perjury setting forth the  
26 facts on which it bases its claim for relief. (Rev. & Tax. Code, § 6592, subd. (b).)

1 ANALYSIS & DISPOSITION

2 Petitioner has filed the requisite request for relief, in which it essentially reiterates its  
3 contentions regarding the audit methodology and its explanation for the lack of records. We have  
4 disposed of these contentions above. Petitioner has not provided any persuasive explanation for its  
5 failure to report all of its taxable sales when it filed its amnesty returns, and thus has not demonstrated  
6 that such failure was due to reasonable cause or circumstances beyond its control. Accordingly we  
7 decline to grant relief from the amnesty penalties.

8 ORDER

9 It is hereby ordered that the petition be denied and that the matter be redetermined without  
10 adjustment.

11 Adopted at Sacramento, California, on November 20, 2013.

12  
13 Jerome E. Horton \_\_\_\_\_, Chairman

14  
15 Michelle Steel \_\_\_\_\_, Member

16  
17 Betty T. Yee \_\_\_\_\_, Member

18  
19 George Runner \_\_\_\_\_, Member

20  
21 Marcy Jo Mandel \_\_\_\_\_, Member\*

22  
23 \*For John Chiang, pursuant to Government Code section 7.9.  
24  
25  
26  
27  
28