

## 1 CALIFORNIA STATE BOARD OF EQUALIZATION

## 2 APPEALS DIVISION BOARD HEARING SUMMARY

3 In the Matter of the Petition for Redetermination )  
 4 and Administrative Hearing under the ) Account Number CP STF 50-004594  
 4 Cigarette and Tobacco Products Tax Law of: ) Case ID 569235  
 5 MOX, INC., dba Max Wholesale ) Account Number CP STF 50-003493  
 6 ) Case ID 570251  
 6 Petitioner/Taxpayer<sup>1</sup> ) Fullerton, Orange County  
 7 \_\_\_\_\_ )

8 Type of Business: Tobacco products distributor  
 9 Liability periods: 01/01/06 – 02/28/06 (Case ID 569235)  
 05/01/04 – 12/31/05 (Case ID 570251)

<u>Item</u>	<u>Disputed Amount</u>			
11 Unreported distributions of tobacco products	\$ 818,203 (Case ID 569235) \$5,109,188 (Case ID 570251)			
12				
13 Fraud penalties	\$ 95,648 (Case ID 569235) \$ 597,264 (Case ID 570251)			
14	<u>569235</u>		<u>570251</u>	
	<u>Tax</u>	<u>Penalty</u>	<u>Tax</u>	<u>Penalty</u>
15 As determined	\$382,591.73	\$229,555.03	\$2,389,056.31	\$608,516.60
16 Finality penalty		38,259.17		
17 Post-D&R adjustment		- 38,259.17		- 11,252.51
17 Revised post-D&R adjustment		-133,907.10		
18 Proposed redetermination, protested			\$2,389,056.31	\$597,264.09
18 Determination, after adjustments	<u>\$382,591.73</u>	<u>\$95,647.93</u>		
19 Proposed tax redetermination			\$2,389,056.31	
20 Determined tax	\$382,591.73			
21 Interest through 09/25/14	260,338.45		1,836,104.21	
21 Fraud penalty	95,647.93		<u>597,264.09</u>	
22 Total tax, interest, and penalty	<u>\$738,578.11</u>		<u>\$4,822,424.61</u>	
23 Monthly interest beginning 09/26/14	<u>\$ 1,912.96</u>		<u>\$ 11,945.28</u>	

24 This matter was scheduled for Board hearing in April 2014, but was postponed at taxpayer's  
 25 request because of illness. It was rescheduled for hearing in July 2014, but was postponed again at  
 26 taxpayer's request because of continued illness and a scheduling conflict for taxpayer's representative.

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 28 <sup>1</sup> For ease of reference, we will use the term "taxpayer" throughout the summary. Where necessary to distinguish between the liabilities, we will refer to the liability period.

1 This appeal involves an amount in controversy that is \$500,000 or more and thus is covered by  
2 Revenue and Taxation Code section 40, as explained below.

### 3 UNRESOLVED ISSUES

4 **Issue 1:** Whether taxpayer is liable for tax on its distributions of tobacco products in California.  
5 We conclude taxpayer is liable.

6 Taxpayer held a cigarette and tobacco products distributor's account that became effective  
7 May 1, 2004. The Special Taxes Policy and Compliance Division of the Property and Special Taxes  
8 Department (Department) closed the account effective December 31, 2005, in accordance with a  
9 request from taxpayer on November 22, 2005. Although taxpayer filed returns throughout the period  
10 that the account was active, it did not report any distribution of untaxed tobacco products in California.

11 On October 17, 2006, a search warrant was executed at Sunrise Tobacco in Phoenix, Arizona.<sup>2</sup>  
12 The records seized included three bills of lading and various sales invoices from which the Department  
13 established that taxpayer had purchased tobacco products from Sunrise Tobacco totaling \$5,109,188  
14 during the period May 1, 2004, through December 31, 2005, and totaling \$818,203 during the period  
15 January 1, 2006, through February 28, 2006. Since taxpayer filed returns showing no distributions for  
16 the earlier period and did not file returns for the latter period, the amounts of purchases for each period  
17 represent the taxable measure determined in the Notices of Determination (NOD) in dispute.

18 The three bills of lading that were obtained from Sunrise Tobacco were created by ABF Freight  
19 Systems, Inc., and list pick up-dates in January and February 2006. They identify Sunrise Tobacco as  
20 the shipper and Max Wholesale as the consignee. On each bill of lading, the contact person listed is  
21 "Lee," with the same phone number adjacent to the name on each bill of lading. The ship-to address  
22 for Max Wholesale on all three documents is a Los Angeles property owned by taxpayer's president,  
23 Kwang Yi. The Investigations and Special Operations Division of the Board's Legal Department  
24 (ISOD) used the weight of the products shipped and an average value of \$16.86 per pound to compute  
25 purchases of \$554,019.60. ISOD also obtained four sales invoices from January 2006 that show "Lee"

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27 <sup>2</sup> The search warrant was executed as part of a joint investigation with the United States Department of Justice, Bureau of  
28 Alcohol, Tobacco, Firearms, and Explosives, the Arizona Department of Revenue, the Federal Bureau of Investigation, and  
the Phoenix Police Department.

1 in the box marked “Ship to.” Also, in a document the Department deemed to be a Sunrise Tobacco  
2 customer list, there is an entry of “Lee,” with a phone number that, according to Board records,  
3 belongs to Kwang Yi. Based on the available evidence, ISOD has concluded that taxpayer’s president,  
4 Kwang Yi, goes by the nickname of “Lee” or “Mr. Lee.” Therefore, ISOD added the purchases of  
5 \$264,183.80 listed on these four invoices to the estimated purchases of \$554,019.60 to establish  
6 purchases for January and February 2006 of \$818,203.40. With regard to the period May 1, 2004,  
7 through December 31, 2005, ISOD noted that 105 sales invoices from Sunrise Tobacco state that the  
8 items are to be shipped to “Lee,” “Lee-LA,” “L-LA,” or “L.” ISOD determined that taxpayer made  
9 those purchases, which totaled \$5,109,188.

10 Taxpayer contends that it did not purchase tobacco products from Sunrise Tobacco. As  
11 support, taxpayer has submitted a letter from Sunrise Tobacco’s president, Akrum Alrahib that states  
12 Mr. Alrahib did not sell tobacco products to Kwang Yi and that he primarily sold tobacco to two  
13 individuals, Ali Tavaf and Ahmad Darwish. Mr. Alrahib acknowledges that a few deliveries were  
14 shipped to Mr. Yi but states that the deliveries were made to Mr. Yi for the sole purpose of forwarding  
15 the product on to other Los Angeles customers. Taxpayer argues that “Lee” on the invoices and bills  
16 of lading refers to Ali Tavaf, since Mr. Tavaf was a customer of Sunrise Tobacco and the name “Ali”  
17 is derived from the Arabic root “L-Y.” Taxpayer further argues that Mr. Yi’s telephone number was  
18 listed on the bills of lading because the product was delivered to Mr. Yi for subsequent pickup by  
19 Mr. Tavaf or Mr. Darwish. Taxpayer further asserts that the fact the telephone number adjacent to  
20 “Lee” on certain documents matches the number in the Board’s records for Mr. Yi is not evidence that  
21 Mr. Yi is “Lee.” In short, taxpayer contends that ISOD has not established that the purchases were  
22 made by taxpayer or that taxpayer made distributions of tobacco products in California.

23 In response, the Department states that records seized from Sunrise Tobacco include  
24 handwritten papers that list balances for and payments made by “Lee.” In addition, one of the  
25 Department’s investigators states that Mr. Yi answered to “Mr. Lee” when she met with him, and  
26 Danny Kim, a special agent of the California Department of Justice, has confirmed that Mr. Yi  
27 identified himself during an interview as Mr. Lee. Further, the Department has submitted a document  
28 found in the records seized at Sunrise Tobacco, titled “Reconstruction of Monthly Sales for August 1,

1 2005, to January 31, 2006, Based on Average Mark Up and Percentages of Sales Volume,” which lists  
2 sales to several California businesses, including Max Wholesale.

3 Taxpayer disputes the Department’s conclusion that Mr. Yi uses the nickname “Mr. Lee,”  
4 asserting that Mr. Yi has limited English-language capabilities and the fact that he may have answered  
5 to “Mr. Lee” could be due to misunderstanding. Taxpayer also asserts that any reference to Mr. Yi’s  
6 response to the name “Mr. Lee” is hearsay and therefore should be disregarded. Further, taxpayer  
7 questions the validity of the evidence cited by the Department. Moreover taxpayer notes that the  
8 reconstruction of monthly sales document shows purchases by Max Wholesale of only \$371,736 for  
9 the period August 1, 2005, through January 31, 2006, which represents average monthly purchases of  
10 \$61,596, which are well below the Department’s estimated purchases. As a result, taxpayer argues that  
11 the reconstruction of monthly sales is evidence that the Department’s estimate should be reduced.

12 We find that the evidence shows taxpayer accepted numerous deliveries of untaxed tobacco  
13 products from Sunrise Tobacco, and taxpayer operated a business selling tobacco products, which is  
14 evidence that taxpayer made sales of tobacco products and/or placed untaxed tobacco products in his  
15 retail stock for the purpose of selling those products to consumers. (See Rev. & Tax. Code, § 30008,  
16 subds. (a), (c).) Taxpayer has not presented any argument or evidence rebutting the presumption that  
17 the tobacco products purchased from Sunrise Tobacco were untaxed and that taxpayer distributed these  
18 products. Therefore, we find that taxpayer is liable for excise taxes on any untaxed tobacco products  
19 that taxpayer distributed during the liability periods.

20 Since taxpayer failed to report its distributions of untaxed tobacco products, and did not  
21 provide complete records, ISOD used the best evidence available to estimate the wholesale cost of  
22 tobacco products distributed by taxpayer. We have concluded that taxpayer made the purchases in  
23 question. In that regard, taxpayer has provided no evidence that the tobacco products were shipped to  
24 taxpayer for the sole purpose of forwarding the product to other Los Angeles customers or that “Lee”  
25 refers to Ali Tavaf. We reject taxpayer’s argument that the amount of purchases should be based on  
26 the reconstruction of monthly sales document. While we accept that document as definitive proof that  
27 taxpayer purchased tobacco products from Sunrise Tobacco, we find the amounts shown thereon to be  
28 unreliable since the bills of lading alone indicate purchases of \$331,477 by taxpayer from Sunrise

1 Tobacco for January 2006, which far exceeds the purchases of \$61,956 reflected by the reconstruction  
2 of monthly sales. We find that the bills of lading and invoices used by ISOD to establish the amount  
3 of purchases represent the most reliable evidence available.

4 We also reject taxpayer's assertion that the name "Lee" and the various permutations of that  
5 name on the invoices and bills of lading do not refer to Mr. Yi. We find the totality of the evidence  
6 supports ISOD's conclusions regarding this matter. Accordingly, we find taxpayer made the purchases  
7 of untaxed tobacco products in question and is liable for the tax on its distribution of those products.

8 **Issue 2:** Whether ISOD has provided clear and convincing evidence of fraud. We find that  
9 ISOD has and that the fraud penalties were properly imposed.<sup>3</sup>

10 ISOD imposed fraud penalties on both NOD's, noting that taxpayer was provided information  
11 about the application of tax to tobacco products and about the reporting and payment requirements.  
12 Also, taxpayer filed Tobacco Distributor's Tax Returns for the period May 2004 through December  
13 2005, although it reported no distributions on any of those returns. Taxpayer disputes the fraud  
14 penalties on the basis that it did not underreport its liability during the period when it held a tobacco  
15 product distributor's license, and that it did not distribute tobacco products in January and February  
16 2006.

17 ISOD must establish fraud by clear and convincing evidence. During both liability periods  
18 taxpayer failed to report its distribution of untaxed tobacco products that it purchased from an  
19 unlicensed, out-of-state vendor. Thus, if taxpayer knew that it owed excise tax on these distributions,  
20 the fraud penalty must be upheld. We find there is ample evidence that taxpayer knew of the tax  
21 requirements and knew that making distributions without reporting the tax was a violation of the law.  
22 We further find that the evidence shows taxpayer knew the tobacco products were untaxed.  
23 Nevertheless, taxpayer failed to report any distributions or pay any amount of tax during the liability  
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26 <sup>3</sup> The NOD issued March 24, 2011, for the period May 1, 2004, through December 31, 2005 (case ID 570251) would not  
27 have been timely for any portion of the liability period absent a finding of fraud because taxpayer filed returns for that  
28 period. However, since taxpayer did not file returns for the period January 1, 2006, through February 28, 2006, the NOD  
issued March 25, 2011, was timely for that period under the 8-year statute of limitations, without regard to the finding of  
fraud. (Rev. & Tax. Code, § 30207.)

1 periods. The complete failure to report anything at all is beyond negligent error and is strong evidence  
2 of fraud. We find that ISOD has established fraud by clear and convincing evidence.

### 3 **RESOLVED ISSUES**

4 The NOD for the period May 1, 2004, through December 31, 2005, included a failure-to-file  
5 penalty of \$11,252.51 for the month of May 2004. However, Board records indicate that taxpayer filed  
6 returns for the entire liability period, and ISOD has acknowledged that the failure-to-file penalty was  
7 imposed in error. Accordingly, we have recommended that that failure-to-file penalty be deleted.

8 The NOD for the period January 1, 2006 through February 28, 2006 includes a failure to file  
9 penalty of \$38,259.17, an unlicensed person penalty of \$95,647.93, and a finality penalty of  
10 \$38,259.17. In a memorandum dated September 11, 2014, the Department now concedes that these  
11 penalties should not have been imposed because petitioner *did* in fact hold a distributor's license  
12 during the audit period, and recommends their deletion (subject to the standard conditions for relieving  
13 the finality penalty). We concur.

14 Mox Inc. (petitioner) held distributor's licenses (LD STF 090-003882 and CP STF 050-  
15 003493) since 2004. On March 16, 2006, petitioner notified the Special Taxes and Fees Division to  
16 close out the distributor's licenses, and by letter dated that same day, the Special Taxes and Fees  
17 Division notified petitioner that the licenses would be closed out effective December 31, 2005 (i.e.,  
18 retroactively). However, upon audit after the closeout, the Investigations Division audit staff  
19 determined that petitioner's records showed that petitioner purchased tobacco products for distribution  
20 during January and February of 2006. Accordingly, on June 6, 2008, the Investigations Division  
21 requested that the closeout date of the distributor's licenses be changed to February 28, 2006.

22 Subsequently, on July 25, 2008, petitioner filed zero returns for January and February of 2006.  
23 Apparently based upon the zero returns (which generally represent that a taxpayer is not operating as a  
24 licensed distributor), the Investigations Division decided to change the closeout date of the  
25 distributor's licenses back to December 31, 2005. The change in closeout date back to December 2005  
26 meant that petitioner was no longer licensed as a distributor, resulting in the assertion of the  
27 aforementioned failure to file, unlicensed person, and finality penalties.

1 The Investigations Division now advises that had petitioner's closeout date remained February  
2 28, 2006 as originally requested, the unlicensed person penalty would not have been imposed.  
3 Moreover, petitioner filed late returns for January and February 2006 on July 25, 2008, at the same  
4 time it filed the late return for May 2004. Because the Investigations Division accepted the May 2004  
5 return (as explained above), the Investigations Division advises that the late returns for January and  
6 February 2006 would also have been accepted, thus avoiding the imposition of the failure to file  
7 penalty for January and February 2006.

8 Lastly, our original hearing summary recommended relief from the finality penalty, subject to  
9 the standard conditions.<sup>4</sup> Now, the Investigations Division advises that had petitioner's distributor's  
10 licenses not been closed out as of December 31, 2005, the liability for January and February 2006  
11 would have been covered by the NOD issued on March 24, 2011, and the finality penalty imposed in  
12 connection with the March 25, 2011 NOD would not have accrued, since a timely petition for  
13 redetermination had been filed in connection with the March 24, 2011 NOD. Accordingly, the  
14 Investigations Division concurs with our recommendation for relief from the finality penalty, if  
15 taxpayer pays the tax amount due within 30 days of the mailing of the notice of final decision in this  
16 appeal.

#### 17 OTHER MATTERS

18 A collection cost recovery fee has been imposed pursuant to Revenue and Taxation Code  
19 section 30354.7. Although we explained to taxpayer that it could request relief of the failure-to-file  
20 penalty and the collection cost recovery fee and explained the procedure for requesting relief, taxpayer  
21 has not submitted the requisite statements signed under penalty of perjury. Accordingly, we have no  
22 basis to consider relief of the collection cost recovery fee.

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25 <sup>4</sup> As explained in our original summary, the finality penalty was imposed because taxpayer submitted a petition for  
26 redetermination by the date stated on the NOD but did not deposit a security. ISOD therefore rejected the petition for  
27 redetermination, although it accepted the appeal as a request for administrative hearing. We find that the NOD did not  
28 include instructions on how to properly file a petition for redetermination as (i.e., by submitting a writing and security  
deposit), as is required by California Code of Regulations, title 18, sections 5222.6 and 5223. Accordingly, we find that the  
finality penalty was not properly imposed and should be deleted if taxpayer pays the tax amount due within 30 days of the  
mailing of the notice of final decision in this appeal.

1 Taxpayer has also alleged offensive and inappropriate behavior by ISOD, objecting specifically  
2 to the interviews ISOD conducted regarding Mr. Yi's identity and to a phone call made to Mr. Yi's  
3 wife. We have suggested that taxpayer contact the Taxpayers' Rights Advocate and have provided the  
4 relevant contact information.

5 Section 40 Matter

6 As noted above, this matter is subject to Revenue and Taxation Code section 40. Therefore,  
7 within 120 days from the date the Board's vote to decide the appeal becomes final, a written opinion  
8 (i.e., Summary Decision or Memorandum Opinion) must be published on the Board's website. (Cal.  
9 Code Regs., tit. 18, § 5552, subds. (b), (f).) The Board's vote to decide the appeal will become final 30  
10 days following the date on which notice of the Board's decision is mailed to the parties, except when a  
11 petition for rehearing is filed within that period.<sup>5</sup> (Cal. Code Regs., tit. 18, § BT: 5561, subd. (a).)

12 Following the conclusion of this hearing, if the Board votes to decide the appeal, but does not  
13 specify whether a Summary Decision or a Memorandum Opinion should be prepared, staff will  
14 expeditiously prepare a non-precedential Summary Decision and submit it to the Board for  
15 consideration at a subsequent meeting. (Cal. Code Regs., tit. 18, § 5551, subd. (b)(2).) Unless the  
16 Board directs otherwise, the proposed Summary Decision would not be confidential pending its  
17 consideration by the Board (Cal. Code Regs., tit. 18 § 5551, subd. (b)(5)); accordingly, it would be  
18 posted on the Public Agenda Notice for the meeting at which the Board will consider and vote on the  
19 Summary Decision.

20 A taxpayer may request that the Board hold in abeyance its vote to decide the appeal so the  
21 taxpayer may review the Board's written opinion prior to the expiration of the 30-day period for the  
22 filing of a petition for rehearing. If the vote is held in abeyance, the proposed Summary Decision will  
23 be confidential until it is adopted by the Board. (Cal. Code Regs., tit. 18, § 5551, subd. (b)(5).) Any  
24 request that the Board's vote be held in abeyance should be made in writing to the Board Proceedings  
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27 <sup>5</sup> If a petition for rehearing is filed, the Board's decision will not become final, and no written opinion under Section 40 will  
28 be considered until after the petition for rehearing is resolved.

1 Division prior to the hearing or as part of oral argument at the hearing. Any such request would then  
2 be considered by the Board during its deliberations on the appeal.

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