STATE BOARD OF EQUALIZATION
SALES AND USE TAX APPEAL

CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION FINAL ACTION SUMMARY

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of:	)	
SHYM CORP., dba Price Cutter Market	)	Account Number SR KH 101-621050 Case ID 611317
Petitioner	)	Sacramento, Sacramento County

Type of Business: Convenience store

Audit period: 07/01/07 – 06/30/10

Item	Disputed Amount
Measure of tax collected but not remitted	$352,962
Disallowed claimed exempt food sales	$169,167
Unreported taxable sales	$131,682
Unreported taxable cigarette rebates	$ 45,029
Negligence penalty	$ 5,868

	Tax	Penalty
As determined	$58,678.30	$13,356.44
Post-D&R adjustment	- 00.00	- 7,488.60
Proposed redetermination, protested	$58,678.30	$ 5,867.84

Proposed tax redetermination	$58,678.30
Interest through 08/31/15	23,936.90
Negligence penalty	5,867.84
Total tax, interest, and penalty	$88,483.04
Payments	- 150.00
Balance due	$88,333.04
Monthly interest beginning 09/01/15	$ 292.64

A Notice of Appeals Conference was mailed to petitioner's address of record, and the notice was not returned by the Post Office. Petitioner did not respond to the notice or appear at the appeals conference, which was held as scheduled. We thereafter sent petitioner two letters offering it the opportunity to provide any additional arguments and evidence in writing it wished us to consider, and it responded to the second letter.

This matter was scheduled for Board hearing in May 2015, but petitioner did not respond to the Notice of Hearing, and it was scheduled for decision on the nonappearance calendar. However, Member Harkey requested that the matter be deferred for further review.

UNRESOLVED ISSUES

Issue 1: Whether adjustments to any of the audited measures of tax are warranted. We conclude that no adjustments are warranted.

Petitioner operated a convenience store from July 2007 through April 2011, when it sold the business. For audit, petitioner provided its federal income tax returns, sales tax worksheets, sales journals, cash register z-tapes, and purchase invoices. The Sales and Use Tax Department (Department) noted material differences between the gross receipts reported on petitioner's income tax returns and the total sales reported on its sales and use tax returns, and attributed the differences to other corporate business income. While the Department found only immaterial differences between the total sales recorded on electronic spreadsheets and petitioner's reported total sales, it found that petitioner's recorded taxable sales and accrued sales tax reimbursement substantially exceeded its reported amounts. Based on the recorded sales tax reimbursement that exceeded the amount remitted, the Department established unreported taxable sales of $352,962.

The Department conducted further testing to verify the accuracy of petitioner's recorded sales. After computing very low or negative book markups for sales of taxable merchandise, and very high book markups (up to 164 percent) for exempt sales of food, the Department concluded that petitioner had made significant errors in ringing up and/or recording its taxable and exempt sales. Using costs shown in a purchase invoice from each vendor that sold exempt food items to petitioner in March or April 2010, and the corresponding shelf prices on May 6, 2010, the Department computed a weighted average markup of 55.06 percent for petitioner's exempt sales. The Department computed audited exempt sales of food by adding the markup of 55.06 percent to audited costs of nontaxable merchandise sold, and found that petitioner's recorded nontaxable sales exceeded audited exempt sales of food by $102,185 for fiscal year ending (FYE) June 30, 2008, $66,983 for FYE June 30, 2009, and by $28,958 for FYE June 30, 2010. Since the Department considered these differences to be taxable sales erroneously rung up as nontaxable sales, it added the differences to petitioner's recorded taxable sales and computed audited taxable markups of 21.9 percent for FYE June 30, 2008, 19.8 percent for FYE June 30, 2009, and 4.4 percent for FYE June 30, 2010. The Department found that the audited taxable markups for FYE June 30, 2008, and FYE June 30, 2009, were acceptable, and established the

difference between claimed and audited exempt sales for those two years of $169,167 as disallowed claimed exempt sales of food.

The Department found that the audited taxable markup of 4.4 percent for FYE June 30, 2010, was not acceptable, and decided that further analysis for that year was required. It reduced the audited cost of taxable merchandise sold for that year by 1 percent for shrinkage, and then added the average audited taxable markup for the prior two years of 20.85 percent to establish audited taxable sales. The Department established the difference of $131,682 between audited taxable sales for FYE June 30, 2010, and petitioner's recorded taxable sales for that year as unreported taxable sales.

Based on information from petitioner's income tax returns, the Department noted that petitioner received cigarette rebate income of $45,029 from R.J. Reynolds and Philip Morris during the audit period, and the Department assessed tax on those rebates.[1]

Petitioner contends that the audit methods of disallowing claimed exempt food sales and assessing recorded vs. reported differences created a double assessment of the sales tax. However, petitioner did not provide any evidence or calculations to support this contention.

We examined the audit work papers and found no evidence of double taxation. We find that the measure of tax for sales tax reimbursement that petitioner collected but did not remit accounts for taxable sales that petitioner recorded but did not report, while the measures of tax for disallowed claimed exempt sales of food, unreported taxable sales, and unreported taxable cigarette rebates account for taxable sales that were not properly recorded. We note that if we add the total deficiency measure established in the audit ($698,840) to petitioner's reported taxable sales of $1,762,179 for the audit period, and compare audited taxable sales thus computed of $2,461,019 with audited costs of taxable merchandise sold of $2,001,515, we compute an overall markup 22.96 percent for taxable merchandise. Although an unusually high audited markup might indicate that the audited taxable measure is overstated, we find that the audited taxable markup of 22.96 percent is rather conservative

[1] Although petitioner has not specifically protested the application of tax to cigarette rebates, a brief analysis is warranted. California Code of Regulations, Title 18, section 1671.1, subdivision (c)(3)(A) expressly provides that such rebates are rebuttably presumed to be subject to tax until the contrary is established, and here, petitioner did not provide any evidence, such as copies of the contracts describing the terms for the rebates, to show that the rebates represented nontaxable income. Therefore, the cigarette rebates that petitioner received in the amount of $45,029 are subject to tax.

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for this industry. Based on the available information, we find that the assessments were not duplicated, and conclude that no adjustments are warranted.

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

The Department initially asserted a 40-percent evasion penalty of $9,984.80 for failure to remit collected sales tax reimbursement, and a 10-percent negligence penalty of $3,371.64 for the other audit items. However, the Department concluded that the evidence of evasion was not sufficient to warrant the 40-percent penalty, and now recommends that the 40-percent penalty be deleted and a 10-percent penalty for negligence be applied to the measure for sales tax reimbursement collected but not remitted. The Department contends that the negligence penalty is warranted because the understatement is substantial. Petitioner did not expressly dispute or concede the penalty.

We note that petitioner's *recorded taxable sales* exceeded its reported taxable sales by more than $347,000 for calendar years 2008 and 2009, which represents an error rate of 31 percent. Further, petitioner's recorded sales tax reimbursement exceeded its reported amounts by more than $29,000 for calendar years 2008 and 2009, which represents an error rate of 32 percent. We conclude that petitioner's failure to report at least the amount of its recorded taxable sales and recorded sales tax reimbursement is strong evidence of negligence. While the Department accepted the accuracy of petitioner's recorded total sales for the first two years of the audit period, it found that petitioner's recorded total sales for the last year of the audit period were significantly understated. We find that petitioner's failure to record all of its sales for the last year of the audit period is additional evidence of negligence. Thus, even though this was petitioner's first audit, we conclude that petitioner was at least negligent. Therefore we recommend that the 40-percent penalty for failure to remit collected sales tax reimbursement be replaced by the negligence penalty.

OTHER MATTERS

In a letter dated September 23, 2014, petitioner's president claims that he decided to sell the business in February 2010, obtained a qualified buyer, opened an escrow, and was immediately flagged for this audit. Petitioner's president does not dispute the quality of the audit work, but opined that the calculations and formulas used in the audit are applicable to audits of mega supermarkets, but not to a small mom-and-pop operation with five employees, such as this one. Petitioner's president

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claims that the amount to be withheld in escrow to cover petitioner's liability was arbitrarily increased, which delayed the closing of escrow, and ultimately resulted in the buyer withdrawing its offer. According to petitioner's president, he eventually found another buyer for the business, but since the selling price for the business was substantially less than the amount that originally had been offered, he received no net proceeds, personally lost two residential homes and all of his savings, and became unemployed. Although we are sympathetic regarding petitioner's president's financial circumstances, we find that there was no information in the letter of September 23, 2014, that warranted any adjustments to the audit liability. Since petitioner failed to attend the appeals conference, we were unable to discuss options for making installment payment arrangements or filing for an Offer in Compromise.

Summary prepared by Lisa Burke, Business Taxes Specialist III

MARKUP TABLE

Percentage of taxable vs. nontaxable purchases	87%
Mark-up percentages developed (nontaxable merchandise) (taxable merchandise FYE June 30, 2010)	55.06% 20.85%
Self-consumption allowed in dollars	$0*
Pilferage allowed in dollars (taxable merchandise FYE June 30, 2010)	$6,751*
Pilferage allowed as a percent of taxable purchases	1%

* For FYE June 30, 2008, and June 30, 2009, the Department established audited exempt sales of food on a markup basis. In that markup analysis, the Department did not reduce audited costs of *nontaxable* merchandise sold to allow for self-consumption or pilferage, because to do so would have resulted in a reduction to audited exempt food sales, which would have been detrimental to petitioner. However, for FYE June 30, 2010, the Department established audited taxable sales on a markup basis. In that markup analysis, the Department did reduce the audited cost of *taxable* merchandise sold to allow for pilferage, which was beneficial to petitioner because the adjustment resulted in a reduction to audited taxable sales.