

CALIFORNIA STATE BOARD OF EQUALIZATION
APPEALS DIVISION BOARD HEARING SUMMARY

In the Matter of the Administrative Protest)
Under the Sales and Use Tax Law of:)
MOHAMMAD K. ABUKHDAIR, dba) Account Number SR KH 100-196111
Cisco's Mini-Mart) Case ID 518237
Taxpayer) Sacramento, Sacramento County

Type of Business: Convenience store
Audit period: 07/01/05 – 06/30/08

<u>Item</u>	<u>Disputed Amount</u>		
Unreported taxable sales	\$282,614		
Negligence penalty	\$ 2,218		
		<u>Tax</u>	<u>Penalty</u>
As determined		\$22,389.41	\$2,238.96
Finality penalty			2,238.94
Adjustment - Appeals Division		- 207.78	- 41.96
Adjusted tax and penalty		<u>\$22,181.63</u>	<u>\$4,435.94</u>
Less concurred		- 279.00	00.00
Balance, protested		<u>\$21,902.63</u>	<u>\$4,435.94</u>
Adjusted tax		\$22,181.63	
Interest through 03/31/12		8,909.23	
Negligence penalty		2,218.18	
Finality penalty		<u>2,217.76</u>	
Total tax, interest, and penalty		\$35,526.80	
Payments		- 4.00	
Balance Due		<u>\$35,522.80</u>	
Monthly interest beginning 04/01/12		<u>\$ 129.37</u>	

A Notice of Appeals Conference was mailed to taxpayer's address of record, and the notice was not returned by the Post Office. Taxpayer did not respond to the notice or appear at the appeals conference, which was held as scheduled. We thereafter sent taxpayer a letter offering him the opportunity to provide any additional arguments and evidence in writing he wished us to consider, and we received a reply from taxpayer's representative that reiterated certain contentions and stated that taxpayer intended to provide additional records. However, no additional records have been provided.

UNRESOLVED ISSUES

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2 **Issue 1:** Whether adjustments are warranted to the amount of unreported taxable sales. We
3 find no further adjustment is warranted.

4 Taxpayer operated a convenience store from April 2003 to May 2010. For audit, taxpayer
5 provided federal income tax returns, purchase invoices, cancelled checks, check stubs, and scattered
6 cash register tapes. The Sales and Use Tax Department (Department) established audited taxable sales
7 on a markup basis, using an audited percentage of 62.49 percent taxable to total merchandise
8 purchases, computed in a purchase segregation test, and an audited markup of 30 percent, computed in
9 a shelf test. The Department made adjustments of \$100 per month for the cost of self-consumed
10 taxable merchandise and 2 percent for pilferage. The Department also made an adjustment for exempt
11 food stamp sales of otherwise-taxable merchandise. The Department computed a percentage of error
12 of 215.35 percent in reported taxable sales for the period January 1, 2006, through June 30, 2008,
13 which it used to compute the understatement for the last two quarters of 2005. In the D&R, we
14 recommended that the Department use the percentage of error for 2006, after adjustments for an extra
15 return taxpayer had filed for the third quarter 2006, to establish the understatement for the last two
16 quarters of 2005.

17 Taxpayer contends that the amount of unreported taxable sales is excessive because: 1) it is not
18 appropriate to use the percentage of error calculated for 2006, 2007, and the first two quarters of 2008
19 to compute the understatement for 2005; 2) the pilferage allowance should be greater than 2 percent; 3)
20 the audited cost of goods sold should be reduced for losses of merchandise from water damage after a
21 fire in 2006; and 4) the audited percentage of taxable to total merchandise purchases should be reduced
22 for 2005 since his sales of cigarettes has increased substantially since that time.

23 As noted, we have recommended an adjustment to the percentage of error applied to the last
24 two quarters of 2005, but the resulting adjustment is less than requested by taxpayer. Taxpayer argues
25 that the percentage of error used to compute the understatement for 2005 should be reduced to 143.016
26 percent, the percentage of error originally computed for 2006. However, for that year, taxpayer's
27 reported sales included amounts reported on two returns for the third quarter 2006, one filed on
28 September 30, 2006, and one filed on October 31, 2006, the date the return was due. Since the

1 amounts shown on the two returns are similar, albeit not identical, and the amounts on each return
2 approximate the average amount shown on the other three returns filed for 2006, we find that taxpayer
3 simply filed a duplicate return for the third quarter 2006, for reasons that are not clear. Accordingly,
4 we have deducted the amount of the duplicate return from the amounts reported for the third quarter
5 2006 and re-computed the percentage of error in reported taxable sales for that year as 201.742
6 percent. We find that it would not be reasonable to include the amounts reported on the duplicate
7 return since the filing of a duplicate return is not representative of taxpayer's typical reporting
8 procedures. Accordingly, we find there is no basis to further reduce the percentage of error used to
9 compute the understatement for the last two quarters of 2005.

10 Regarding the amount of pilferage allowed, the Department used 2 percent, which is higher
11 than the standard 1 percent allowance, because the business was located in an area where businesses
12 often experience higher levels of theft. Taxpayer has provided no persuasive evidence that the 2
13 percent allowance is insufficient. With respect to the losses from water damage following a fire,
14 taxpayer has provided no evidence of the loss. Further, if taxpayer had been required to purchase
15 significant amounts of inventory to replace the merchandise lost in this manner, we would expect the
16 book markup for 2006 to be lower than the other years, which it was not. Thus, we find there is no
17 basis for an adjustment to the cost of goods sold for a loss due to water damage.

18 Regarding taxpayer's assertion that the percentage of taxable to total merchandise purchases is
19 excessive for 2005 because his sales of cigarettes had increased, he has provided no evidence of
20 changes in the types of merchandise sold over the audit period. Further, the percentage of taxable to
21 total merchandise purchases of 62 percent is already significant lower than we would expect in a
22 convenience store (generally at least 80 percent). Moreover, if the percentages of merchandise in
23 various categories were revised, reducing the percentage of cigarettes, the audited markup would
24 increase dramatically since the audited markup of 20.4 percent for cigarettes is significantly lower than
25 the markups of 50.9 percent and 89.1 percent for carbonated beverages and miscellaneous taxable
26 items, respectively. Thus, if proved accurate, this argument could result in an increase, rather than a
27 decrease, in the understatement. For all these reasons, we find no further adjustment is warranted.

28 **Issue 2:** Whether taxpayer was negligent. We conclude that he was.

1 The Department imposed the negligence penalty because the gross receipts and the cost of
2 goods sold reported on taxpayer's federal tax returns substantially exceeded the total sales reported on
3 the sales and use tax returns, and the percent of understatement was in excess of 200 percent.

4 Taxpayer reported *cost of goods sold* on his federal tax returns of \$144,909 for 2006 and
5 \$218,760 for 2007. For those same respective years, he reported *total sales* on sales and use tax
6 returns of \$84,334 and \$111,071. We find that taxpayer's failure to recognize that reported total sales
7 were substantially lower than the recorded cost of goods sold is strong evidence of negligence,
8 particularly in concert with the overall reporting error rate of 213 percent, after the most recent
9 adjustment ($\$282,614 \div \$132,480$). We find that errors of this magnitude support the application of
10 the negligence penalty even though taxpayer had not been audited previously.

11 **OTHER MATTERS**

12 Since taxpayer did not timely pay the determination or file a petition for redetermination, a
13 finality penalty was applied. Although we explained to taxpayer that relief of the finality penalty could
14 be granted under certain circumstances and provided a form he could use to request relief, taxpayer has
15 not done so. Accordingly, we have no basis to consider recommending relief of the finality penalty.

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

Percentage of taxable vs. nontaxable purchases	62.49%
Mark-up percentage developed	30%
Self-consumption allowed in dollars	\$1,200 per year
Self-consumption allowed as a percent of taxable purchases	1.03%
Pilferage allowed in dollars	\$5,824 for period 1/1/06-6/30/08
Pilferage allowed as a percent of taxable purchases	2%