STATE BOARD OF EQUALIZATION
SALES AND USE TAX APPEAL

CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION BOARD HEARING SUMMARY

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of:	
BRMAWA CORPORATION, dba Jug's Liquor Mart	Account Number: SR AS 97-608566 Case ID 426212
Petitioner	Lawndale, Los Angeles County

Type of Business: Liquor stores

Audit period: 07/01/04 – 02/19/07

Item	Disputed Amount
Unreported taxable sales	$352,843
Negligence penalty	$ 2,993

	Tax	Penalty
As determined	$37,195.09	$3,719.56
Post-D&R adjustments	- 7,260.49	- 726.09
Proposed redetermination	$29,934.60	$2,993.47
Less concurred	- 825.33	00.00
Balance, protested	$29,109.27	$2,993.47

Proposed tax redetermination	$29,934.60
Interest through 7/31/13	15,339.23
Negligence penalty	2,993.47
Total tax, interest, and penalty	$48,267.30
Less payments	-17,472.60
Balance Due	$30,794.70
Monthly interest beginning 8/1/13	$ 62.31

UNRESOLVED ISSUES

Issue 1: Whether additional adjustments to the amount of unreported taxable sales are warranted. We find no further adjustments are warranted.

Petitioner operated two liquor stores during the audit period, but sold one of the stores in June 2005, and sold the other store in February 2007. For audit, petitioner provided sales and use tax returns, federal income tax returns, an incomplete set of purchase invoices, and financial statements. The Sales and Use Tax Department (Department) used petitioner's recorded taxable sales and the taxable cost of goods sold recorded in its consolidated profit and loss statements to compute a book markup of 9.84 percent, which was much lower than expected. The Department decided to establish audited taxable sales on a markup basis, but was unable to conduct a shelf test or purchase segregation test because petitioner had sold the business several months prior to the start of audit field work and the purchase invoices on hand were incomplete. Therefore, the Department used the markup of 34.91 percent and the taxable merchandise purchase ratio of 87 percent that it had calculated in petitioner's prior audit, for the period July 1, 2000, through March 31, 2004, to establish audited taxable sales. A comparison of audited and reported taxable sales showed reporting error rates of 36.63 percent, 72.08 percent, and 12.51 percent for 2004, 2005, and 2006, respectively, which the Department applied to reported taxable sales for the respective quarterly periods to calculate unreported taxable sales of $415,849 for the audit period.

Petitioner contends that the amount of cost of goods sold reported on its income tax return for 2005 was based on estimates, and indicates that it plans to amend its income tax return for 2005 to correct its reported cost of goods sold from $594,883 to $521,045. Petitioner also argued that the cost of goods sold for 2005 should be reduced to exclude the cost of the inventory sold as part of the sale of one of its stores. As support, petitioner provided a copy of an escrow company closing statement showing $31,829 as the value of inventory that was included in petitioner's sale of its store.

Based on the documentation from the escrow company, we recommended that the cost of goods sold for 2005 be reduced by $31,829. We also recommended that the cost of goods sold be further reduced to allow for costs of self-consumed taxable merchandise and shrinkage. Pursuant to our recommendations, the Department performed a reaudit to reduce the cost of goods sold by 1 percent for self-consumption, and by 1 percent for shrinkage, a second reaudit to reduce the cost of goods sold by $31,829, and a third reaudit to correct minor computation errors. After all adjustments, the understatement of reported taxable sales was reduced by $63,006, from $415,849 to $352,843. Additionally, a separate deficiency measure of $10,000 for unreported taxable costs of self-consumed merchandise was established. Since petitioner did not provide an amended income tax return or other evidence showing that any other reduction to the cost of goods sold is warranted, we recommend no other adjustment.

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

The Department imposed the negligence penalty because it found petitioner's books and records to be inadequate for sales and use tax purposes, and because the errors found in the audit at issue are the same types of errors found in petitioner's two prior audits. Petitioner argues that it did its best to report its sales accurately, and therefore was not negligent.

Significant deficiency measures for unreported taxable sales based on a markup analysis were found in both of petitioner's prior audits and the audit at issue in this case, as well as deficiency measures for unreported taxable costs of self-consumed merchandise. We find that petitioner's failure to take steps to correct its errors and improve the accuracy of its reporting from one audit period to the next is strong evidence that petitioner was negligent. A comparison of unreported taxable sales of $352,843, following the adjustments in the reaudits, with reported taxable sales of $879,027shows a reporting error rate of 40 percent, which is substantial and constitutes additional evidence of negligence. Accordingly, we find that petitioner was negligent and the penalty was properly applied.

RESOLVED ISSUE

Petitioner sold two business locations during the audit period and provided escrow instructions related to those sales, but no sales contracts. The escrow instructions indicate that the sales price of fixed assets at one location was $6,000, and at the other location was $5,000. Petitioner had reported fixed asset sales on its sales and use tax returns of $10,000 for one location and $5,000 for the other location. The Department had used the purchase price of the assets from petitioner's balance sheet to establish an understatement of reported sales of fixed assets of $35,000, and we recommended no adjustment in the D&R. However, during our review of this matter for the Board hearing, we reconsidered our analysis and asked the Department to again examine the records related to the sale of the business locations. As a result, the Department has concluded that the reported sales of fixed assets were substantially correct. We concur, and we recommend that the unreported sales of fixed assets be deleted.

OTHER MATTERS

During its review of this matter for the Board hearing, the Department noted some additional information regarding the cost of goods sold that is not reflected in the D&R or in the discussion of Issue 1 above. The additional facts are presented for information only and do not alter our conclusion.

STATE BOARD OF EQUALIZATION
SALES AND USE TAX APPEAL

Petitioner reported a cost of goods sold of $594,883 on its 2005 income tax return dated June 11, 2007. However, on August 20, 2007, petitioner's representative sent a letter to the Department indicating that an amended return had been prepared and would be filed as soon as the representative returned from Alabama. Since petitioner failed to provide a copy of an amended return by April 2008, and the Department found that the Franchise Tax Board (FTB) had no record of an amended return for 2005 from petitioner, the Department concluded that the cost of goods sold shown in the income tax return dated June 11, 2007, was accurate. On appeal, petitioner provided a different 2005 income tax return dated June 21, 2010, which shows a lower cost of goods sold of $521,045. However, the Department notes that the new income tax return is not signed, and is not on the proper form for filing an amended return. Also, petitioner failed to provide a copy of the confirmation that the FTB sends when it receives an amended return, and copies of reconciliation schedules that the IRS requires for all amended returns. Moreover, on July 9, 2013, the Board's Disclosure Officer verified in a phone call with the FTB that the FTB did not receive an amended 2005 return from petitioner. In the absence of verification that petitioner corrected its reported cost of goods sold for 2005 on an amended return, we conclude that no adjustments are warranted to the audited cost of goods sold for 2005, which is based on the amount petitioner reported on its 2005 income tax return dated June 11, 2007.

Summary prepared by Lisa Burke, Business Taxes Specialist III

MARKUP TABLE

Percentage of taxable vs. nontaxable purchases	87%
Mark-up percentage developed	34.91%
Self-consumption allowed in dollars	$12,338 for the years 2004, 2005, & 2006*
Self-consumption allowed as a percent of taxable purchases	1%
Pilferage allowed in dollars	$12,338 for the years 2004, 2005, & 2006
Pilferage allowed as a percent of taxable purchases	1%

* The Department computed the cost of self-consumption (at 1%) of $12,338 for the years 2004, 2005, and 2006. However, since the audit period is less than two years, eight months, the Department established the cost of self-consumption subject to use tax at a lower amount of $10,000.