CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION SUMMARY FOR BOARD HEARING

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of: KAMAL F. BATECH and WAFAA E. BATECH, dba Mike's Market and Liquor & JR Market and Liquor Petitioner	Account Number: SR EH 97-235573 Case ID 406741 Rancho Cucamonga, San Bernardino County

Type of Business: Liquor stores

Audit period: 07/01/02 – 12/31/05

Item	Disputed Amount
Unreported sales	$585,806
Unreported cigarette rebates	$ 24,064
Negligence penalty	$ 12,687
Amnesty double negligence penalty	$ 1,682
Amnesty interest penalty	$ 1,529

	Tax	Penalty
As determined and proposed to be redetermined:	$126,874.55	$14,369.00
Less concurred	- 79,609.60	00.00
Balance, protested	$ 47,264.95	$14,369.00

Proposed tax redetermination	$126,874.55
Interest through 6/30/10	68,538.39
10% penalty for negligence	12,687.46
Amnesty double negligence penalty	1,681.54
Amnesty interest penalty	1,529.10
Total tax, interest, and penalty	$211,311.04
Monthly interest beginning 7/1/10	$ 740.10

UNRESOLVED ISSUES

Issue 1: Whether adjustments are warranted to the audited understatement of reported sales. We recommend no adjustments.

During the audit period, petitioner operated two liquor stores, Mike's Market and Liquor (Mike's Market), and JR Market and Liquor (JR Market). The Sales and Use Tax Department (Department) used reported taxable sales and recorded purchases of taxable merchandise to compute book markups for each year or partial year, for each of petitioner's stores. For this type of business, the Department expected to see markups of 25 to 45 percent. However, for JR Market & Liquor, the Department computed book markups in the negative range for every year or partial year (a negative markup means recorded purchases were more than reported sales) ranging from -28.9 percent to -32.99 percent. For Mike's Market & Liquor, the Department computed book markups in the negative range for two years (-14.74 percent and -1.02 percent) and in the positive range for the partial year of 2002 (8.29 percent) and 2005 (12.26 percent). The Department concluded that sales were understated and decided to establish audited taxable sales on a markup basis.

For both stores, the Department compiled recorded purchases for the audit period of soda, beer, wine, liquor, cigarettes, fountain drinks, and miscellaneous taxable merchandise. To establish the audited cost of taxable goods sold, the Department reduced audited purchases of soda and cigarettes by estimated costs of self-consumed merchandise of $50 per month and $150 per month, respectively, and for pilferage losses, computed at 1 percent. The Department then conducted shelf tests to compute audited markups. For Mike's Market, the Department computed individual markups for each of the categories of taxable merchandise, and averaged those markups with the markups computed in the prior audit of the period July 1, 1999, through June 30, 2002, to compute audited markups of 46.95 percent for soda, 25.3 percent for beer, 64.93 percent for wine, 53.66 percent for liquor, 17.84 percent for cigarettes, and 47.57 percent for miscellaneous taxable merchandise. For fountain drinks, the Department used the markup of 300.44 percent computed in the prior audit. It applied those markups to the audited cost of goods sold in each category for the audit period to compute audited taxable sales. Upon comparison of audited taxable sales to reported amounts, the Department computed a percentage of error of 30.1 percent, which it applied to reported taxable sales for each quarter of the audit period.

For JR Market, the Department conducted shelf tests to compute audited markups for the audit period of 46.52 percent for soda, 24.53 percent for beer, 37.84 percent for liquor, 11.00 percent for cigarettes, and 54.59 percent for miscellaneous taxable merchandise. For wine, the Department used the markup of 65.45 percent[1] computed in the shelf test for Mike's Market, and for fountain drinks, the Department used the markup of 178.61 percent from the prior audit. The Department computed a weighted average markup of 31.4 percent. It averaged that markup with the weighted average markup computed in the prior audit of 32.05 percent to establish the audited markup of 31.73 percent. The Department used the 31.73 percent markup and the audited cost of all taxable goods sold for each year or partial year of the audit period to compute audited taxable sales. Upon comparison of audited taxable sales with reported amounts, the Department computed percentages of error of 93.22 percent for the last six months of 2002, 82.63 percent for 2003, 85.38 percent for 2004, and 93.78 percent for 2005, which it applied to the reported quarterly amounts.

Petitioner contends that the amount of audited taxable sales should be reduced because: 1) the audited markups are excessive; 2) sales at Mike's Market declined in 2005 due to a major construction project; 3) the audited allowance for pilferage should be increased; and 4) the audited cost of taxable goods sold should be adjusted for inventories.

Petitioner contends, based on its own shelf tests, that the beer markup and soda markup for both stores should be 10.97 percent and 11.51 percent, respectively, and the overall markup for both stores should be reduced to 23.23 percent. Petitioner also contends that the Department should not have utilized the markups computed in the prior audit in its computation of markups for this audit period. We note that petitioner has used selling prices in its shelf tests that are not supported by cash register tapes or price lists. Also, petitioner's shelf tests utilize costs and selling prices for a small number of invoices, rather than an entire purchasing cycle. In contrast, the Department used selling prices observed at the time of the shelf test and included purchases for a complete purchasing cycle in its shelf test. Accordingly, we find that the shelf tests conducted by the Department are more reliable than those provided by petitioner, and petitioner's shelf test does not provide sufficient evidence to support any adjustments.

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[1] The 65.45 percent markup for wine was computed in the shelf test for Mike's Market for the current audit period. The Department computed the average of that markup and the markup of 64.4 percent from the prior audit to establish the audited markup for wine for Mike's Market of 64.93 percent.

With respect to petitioner's contention that the markups computed in the prior audit should not be used in the computation of markups for this audit period, we note that the overall weighted average markups for the current and prior audits are quite similar. For Mike's Market, we have computed weighted average markups of 33.19 percent for the current audit and 33.98 percent for the prior audit, and for JR Market, the weighted average markups were 32.05 percent and 31.4 percent, respectively, for the current audit and the prior audit. Thus, the Department's use of an average of the audited markups for the two audit periods had minimal impact, since it resulted in a minor increase in the markups for Mike's Market and a decrease in the audited weighted average markup for JR Market. Further, the prior audit period ended June 30, 2002, and the current audit period began the following day. Thus, the shelf test for the prior period would have been conducted using purchase costs and selling prices from the current audit period,[2] and are therefore representative of the markup for this audit period. We find there is no basis to exclude the markups computed for the prior audit from the computations of the markups here.

To support its contention that sales for Mike's Market declined because of a nearby construction project (referred to as the "Sanbag" project by petitioner), petitioner has provided a schedule showing a decline in sales for Mike's Market from $1,089,594 in 2004 to $1,015,424 in 2005, and to $635,140 in 2006. Since petitioner's schedule is not supported by the records, and petitioner has not provided other supporting evidence, we find petitioner's schedule unpersuasive. Moreover, we note that the markup method used in the audit is based directly on recorded purchases. Thus, it accounts for fluctuations in sales, which are directly proportional to fluctuations in purchases. We note that recorded purchases of taxable merchandise by Mike's Market did decline in 2005, and audited sales of taxable merchandise declined from $668,638 for 2004 to $549,394 for 2005. We find that the audit properly accounts for a decline in sales at Mike's market in 2005, which may have been caused, at least in part, by the Sanbag project.

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[2] We do not know the specifics of the shelf tests for the prior audit because the Department is unable to locate the audit workpapers.

Petitioner has provided no evidence that pilferage losses exceeded 1 percent, which is the standard allowance. Also, the Department's observation did not disclose that the businesses were located in bad neighborhoods. We find no basis for an increase in the adjustment for pilferage. Similarly, petitioner has not provided evidence to support any adjustments for inventory increases. The amounts of inventory reported on petitioner's federal income tax returns (FITR's) increased by 89.6 percent, from $60,780 on January 1, 2002, to $115,250 on January 1, 2005, for Mike's Market, and increased by 177.9 percent, from $82,575 on January 1, 2002, to $229,450 on January 1, 2005, for JR Market. However, the amounts of inventory reported on FITR's are not supported by detailed inventories, and we find them unreliable. In addition, we note that, based on our experience examining audits, we expect inventory for a liquor store to remain relatively constant unless the shelf space or storage space of the business has increased. We find it improbable that the inventory would almost double or almost triple during a three-year period. For all these reasons, we find that there is insufficient evidence of increases in inventory, and we recommend no adjustment.

Issue 2: Whether the rebates petitioner received from cigarette manufacturers represent gross receipts subject to tax. We find that they do.

Using information from petitioner's FITR's and federal forms 1099, the Department compiled rebates received from cigarette manufacturers of $24,062 for both stores combined. The Department found that the rebates represented gross receipts subject to tax because they were based on a specific reduction in the retail selling price of cigarettes. Petitioner contends that the rebates were not subject to tax because the rebates were dealer incentives rather than gross receipts. Petitioner also argues that the Department has the burden of proof to show that the rebates are subject to tax. In fact, all gross receipts are presumed subject to tax until proven otherwise by the retailer. (Rev. & Tax. Code, § 6091.) Thus, petitioner, rather than the Department, has the burden of proving the nature of the rebates. Petitioner has not shown that any of the rebate amounts were related to display rentals. In the absence of evidence to the contrary, we find that the rebates were made in connection with retail sales of tangible personal property and involved reductions of petitioner's selling price by an amount equivalent to the rebates. Thus, the rebates were amounts received from a third party (the manufacturer) in connection with a sale of tangible personal property, and they represent gross receipts subject to tax.

Issue 3: Whether petitioner was negligence. We conclude that it was.

The Department imposed the penalty because the amount of understatement was significant in relation to the reported measure of tax, and the errors made during this audit period were the same types of errors identified in the prior audit. Petitioner disputes the penalty on the basis that it did the best it could to report its sales accurately.

The prior audit reflected an understatement of $589,266 in reported taxable sales, established on a markup basis, and an unreported cost of self-consumed taxable merchandise of $11,600. The audit here reflects an understatement of $1,596,226 in reported taxable sales, established on a markup basis, an unreported cost of self-consumed taxable merchandise of $16,800, and unreported rebates from cigarette manufacturers of $24,064. Thus, petitioner's errors in reporting taxable sales and its failure to report the cost of self-consumed taxable merchandise continued from one audit period to the next. Moreover, the amount of unreported taxable sales in the current audit is almost three times the amount in the prior audit, indicating that the accuracy and effectiveness of petitioner's record-keeping and reporting procedures declined after the prior audit. We find petitioner's failure to correct errors identified in the prior audit to be evidence of negligence. Further, the amounts of reported taxable sales were less than the recorded costs of that merchandise for most of the audit period for Mike's Market and for all of the audit period for JR Market. We find that any business person, even one with limited experience, should have recognized that it was recording costs that exceeded its reported sales. Thus, we conclude that petitioner, who has operated this business since May 1998 and who we therefore consider reasonably knowledgeable about the business, did not exercise due care in record keeping and reporting. Further, petitioner has acknowledged, in its schedules provided during the appeals process, that the percentage of error was at least 36 percent. Petitioner has not provided a non-negligent explanation for an understatement of that magnitude. Accordingly, we find that the understatement was the result of negligence, and the penalty has been properly applied.

AMNESTY

Although petitioner filed an application for amnesty and filed amnesty returns for periods included in the *prior* audit, it did not file amnesty returns for the amnesty-eligible periods in this audit (July 1, 2002, through December 31, 2002), or pay the tax and interest due for those periods by March 31, 2005. Accordingly, the determination included an amnesty double negligence penalty of $1,681.54. Also, an amnesty interest penalty of $1,529.10 will be added when the liability becomes final. At the appeals conference, we explained to petitioner that it could request relief from the amnesty penalties, under Revenue and Taxation Code section 6592, and provided a form petitioner could use to request relief. Petitioner did not complete that form or otherwise request relief. Thus, we have no basis to consider whether relief of the amnesty penalties is warranted.

OTHER DEVELOPMENTS

None.

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

MARKUP TABLE

	Mike's Market	JR Market
Percentage of taxable vs. nontaxable purchases	Unknown*	Unknown*
Mark-up percentages developed	47.57% -misc. taxable 46.95% - soda 25.30% - beer 64.93% - wine 53.66% - liquor 17.84% - cigarettes 300.44% - fountain drinks 33.59% - overall**	Prior Audit / Current Audit 42.53% 54.59% 44.10% 46.52% 28.43% 24.53% 37.49% 65.45% 58.96% 37.84% 15.37% 11.00% 178.61% 178.61% 31.73% - overall***
Self-consumption allowed in dollars	$8,400 for the audit period	$8,400 for the audit period, with $2,400 allowed for each year or portion thereof
Self-consumption allowed as a percent of total purchases	0.55%%	0.45%
Pilferage allowed in dollars	$15,163	$18,709
Pilferage allowed as a percent of total purchases	1%	1%

* The Department did not compute a percentage of taxable to total purchases for either store. For Mike's Market, it computed total purchases in each category for the audit period. It then applied the audited markup factor to the audited costs of goods sold in that category to establish audited taxable sales per category. For JR Market, the Department computed total purchases in each category. It then computed a weighted average markup of 31.73 percent, which it applied to each audited cost of taxable goods sold, by category.

** For Mike's Market, the Department did not compute an overall weighted average markup, but we have computed the weighted average markup of 33.59 percent, as stated in the D&R.

*** To compute the overall weighted average markup for JR Market, the Department computed the average weighted markup for the prior audit (32.05%) and the average weighted markup for the current audit period (31.40%) and then computed the average of the two, 31.73%.