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:	)	
RAMI MICHELL DARGHALLI, dba Smoke 4 Less	)	Account Number: SR Y AR 97-264029 Case ID 402639
Petitioner	)	Lancaster, Los Angeles County

Type of Business: Tobacco stores

Audit Period: 10/1/02 – 6/28/04

Item	Amount in Dispute
Unreported sales based on a markup analysis	$1,036,720
Unreported sales of other tobacco products	$375,427

	Tax	Penalties
As determined	$101,167.72	$10,116.78
Adjustments: Sales and Use Tax Department	-890.99	1,024.55
Appeals Division[1]	20,315.30	1,925.54
Proposed redetermination	$120,592.03	$13,066.87
Amount concurred in	-4,089.86	-13,066.87[2]
Protested	$116,502.17	$0.00

Proposed tax redetermination	$120,592.03
Interest through 1/31/11	73,852.13
Negligence penalty	12,059.23
Amnesty double negligence penalty	1,007.64
Amnesty interest penalty	676.99
Total tax, interest, and penalties	$208,188.02
Monthly interest beginning 2/1/11	$703.45

This matter was scheduled for Board hearing on May 27, 2009, but was postponed so that the Sales and Use Tax Department (Department) could review new information provided by the Board's Investigations Division regarding additional purchases of other tobacco products made by petitioner that were not accounted for in the audit. The Department prepared a reaudit as discussed below under

[1] Increase asserted by Sales and Use Tax Department pursuant to Revenue and Taxation Code section 6563.
[2] At the appeals conference, petitioner specifically conceded that he was negligent.

"Other Developments." The matter was then rescheduled for Board hearing on July 15, 2010, but petitioner waived his appearance at the hearing. Accordingly, the Board Proceedings Division informed petitioner that this matter would be presented to the Board for decision without oral hearing. Subsequently, petitioner contacted the Board Proceedings Division to request a Board hearing because he had new documentation to present to the Board. This matter was rescheduled for Board hearing on November 17, 2010, but petitioner again waived his appearance, and was thus informed that this matter would be presented to the Board for decision without oral hearing. Subsequently, petitioner's representative contacted the Board Proceedings Division to request that this matter again be placed on the oral hearing calendar.

UNRESOLVED ISSUE

Issue: Whether adjustments are warranted to the unreported taxable sales. We recommend no further adjustments.

Using gross receipts and costs reported on petitioner's federal income tax returns for 2002, 2003, and 2004, the Department calculated book markups of -18.404 percent for 2002, -11.176 percent for 2003, and 9.618 percent for 2004, for an overall book markup of -8.382 percent. Since a negative book markup means that the records reflect sales of goods at prices below cost, the Department concluded that petitioner's reported sales were substantially understated and decided to establish taxable sales on a markup basis. The Department conducted shelf tests to calculate markups of 11.70 percent for cigarettes and 41.92 percent for cigars, and it estimated a markup of 50 percent for miscellaneous taxable merchandise. Using percentages of purchases in each category, as established in a purchase segregation test, the Department calculated an overall weighted average audited markup for taxable merchandise of 12.983 percent.

To establish audited merchandise purchases, the Department first computed petitioner's cigarette purchases, using cigarette purchases from Philip Morris and a calculated percentage of cigarette purchases from Philip Morris to total cigarette purchases. It then divided total cigarette purchases by 95.811 percent, the audited ratio of cigarette purchases to total merchandise purchases, based on the aforementioned purchase segregation test. Comparing audited purchases of $623,496 for 2002 and $693,456 for 2003 to recorded purchases for the same years, the Department computed an error rate in recorded purchases of 149.816 percent. The Department applied the 149.816 percent error rate computed for 2002 and 2003 to recorded purchases for the period January 1, 2004, through June 28, 2004, to establish audited costs for that period of $675,856. The Department reduced audited merchandise costs for 2002 by $24,200 for a documented theft based on a police report, and allowed no other adjustments for shrinkage or self-consumption. We concluded that the theft was actually for a related business also currently under appeal, and recommended that the loss be allowed for the related business (account number SR Y AR 97-883995, Case ID 404171) and deleted from this matter. The D&R also recommended adjustments for shrinkage, computed at one percent, and for an audited cost of self-consumed merchandise, estimated at $100 per month. Using those adjusted audited amounts of merchandise purchases and the audited markup of 12.983 percent, the Department computed taxable merchandise sales of $696,058 for 2002, $774,310 for 2003, and $755,295 for 2004. Audited taxable sales for 2002 and 2003 were then reduced by cigarette buydowns (no buydowns were made in 2004, because Philip Morris discontinued its buydown program in February 2003) to establish taxable merchandise sales of $626,830 for 2002, $757,139 for 2003, and $755,295 for 2004. Upon comparison to reported taxable sales of $175,961, $161,009, and $289,907 for the same respective periods, the Department computed error rates of 256.232 percent for 2002, 370.246 percent for 2003, and 160.530 percent for 2004. Upon projection to the audit period in the reaudit we recommended, the Department reduced unreported taxable sales by $3,263 from the original audit, from $1,173,864 to $1,170,601.

Petitioner contends that the amount of unreported taxable sales is excessive, arguing that the Department's analysis is based on erroneous assumptions. Petitioner explains he operated several other tobacco shops, liquor stores, and mini-marts in the area during the period at issue. Petitioner asserts that, although these businesses were separate entities with separate seller's permits, petitioner regarded them as branches of the same general business and bought merchandise in bulk through one store for distribution to several locations. Petitioner claims these bulk purchases were generally recorded on the purchasing store's books, but that, following delivery of the merchandise by the vendor, the merchandise was physically divided among several store locations.

Petitioner has not provided any evidence of the alleged inventory transfers between businesses. Since ownership of the businesses was not identical (most of the related accounts are partnerships), we believe inter-company transfers would have been reflected in the books of each entity, and unrecorded transfers would be unlikely because the transfers (or lack thereof) would have had a direct bearing on the net profit or loss of each entity. In addition, petitioner stated that several of the related entities were audited concurrently with this account. Based on the Board's computerized records, we were able to identify three related accounts which were audited, and those audits were all performed on a mark-up basis. Since the alleged transfers were not recorded or otherwise identified in any of the books of the related entities, it is evident that the measure of tax has not been duplicated for the alleged inter-company transfers.

Moreover, we note that most of the related businesses are liquor stores, which generally do not sell cigarettes in volumes as large as a store specializing in sales of cigarettes and tobacco products. We therefore believe that, if petitioner had actually made any transfers of cigarettes to a related entity, the transfer would have been to the partnership of petitioner and Faiz Mohamed Munassar, dba Smoke 4 Less #2 (SR Y AR 97-883995), which also specialized in sales of cigarettes and tobacco products. Since the statute of limitations has not expired for Smoke 4 Less #2, any recommended adjustment for a transfer of inventory to Smoke 4 Less #2 would essentially just shift the tax liability from one account to another and would have a minimal overall tax consequence. In any event, we find that petitioner has not established any such inventory transfer, and we conclude that no further adjustments are warranted.

AMNESTY

Petitioner did not participate in the amnesty program, and an amnesty double negligence penalty of $1,007.64 was asserted on December 21, 2009, as discussed under Other Developments, below. (Rev. & Tax. Code § 7073, subd. (c).) Also, an amnesty interest penalty of $856.51 will be imposed when the liability becomes final. (Rev. & Tax. Code § 7074, subd. (a).)

Petitioner has indicated that he does not protest any amnesty penalty that might apply. Nevertheless, we informed petitioner of the provisions for relief of amnesty penalties under Revenue and Taxation Code section 6592; petitioner responded that he would not request relief or submit the required statement under penalty of perjury. However, pursuant to the Board's order at its meeting on March 18, 2008, we recommend that $179.52 of the amnesty interest penalty, which is the portion related to cigarette rebates, be relieved provided that, within 30 days of the Notice of Redetermination, petitioner either pays the amnesty-eligible portion of the tax and interest related to cigarette rebates or enters into a qualifying installment agreement to do so and successfully completes that agreement. This would reduce the amnesty interest penalty to $676.99 ($856.51 - $179.52). We find there is no basis to recommend relief of the remainder of the amnesty penalties.

OTHER DEVELOPMENTS

Prior to the Board hearing scheduled on May 27, 2009, the Investigations Division found, and informed the Department, that petitioner had purchased other tobacco products from an out-of-state supplier, The House of Oxford, which were not included in the audit. Based on its review, the Department concurred with the findings of the Investigations Division. Thus, in a second reaudit, the Department used the additional purchases to compute taxable sales of other tobacco products of $375,427. Additionally, the Department adjusted the selling price of cigarettes for inflation and recalculated audited taxable sales, which resulted in reducing the understatement of reported taxable sales from $1,170,601 to $1,036,720. Finally, self consumption was increased from $2,100 to $6,800. These adjustments, in total, increased the audited taxable measure from $1,215,475 in the first reaudit to $1,461,721 in the second reaudit ($1,036,720 for unreported taxable sales, $375,427 for the separately stated sales of other tobacco products established in the second reaudit, $6,800 for self consumption of cigarettes, and $42,774 for unreported taxable cigarette rebates) or an increase in tax from $100,276.73 to $120,592.03. By letter dated December 21, 2009, the Department asserted the increase in tax and penalty, including the addition of the amnesty double negligence penalty of $1,007.64, pursuant to Revenue and Taxation Code section 6563. Petitioner has not specifically protested the separately stated amount of unreported taxable sales of other tobacco products. The evidence shows that these purchases were not recorded in petitioner's books and records, and in the absence of arguments or evidence regarding this issue, we recommend no adjustment to the separately stated amount of unreported taxable sales of other tobacco products.

Summary prepared by Rey Obligacion, Retired Annuitant

MARKUP TABLE

Percentage of taxable vs. nontaxable purchases	100%*
Mark-up percentage developed	12.983%
Self-consumption allowed in dollars	$6,800
Self-consumption allowed per month	$100 per month per location
Pilferage allowed in dollars	$18,324
Pilferage allowed as a percent of total purchases	1%

* Unreported taxable sales were established on analysis of taxable purchases only. Petitioner did claim exempt food sales of $3,207 for the audit period while reporting taxable sales of $489,328 on his sales and use tax returns. Based on petitioner's sales and use tax returns, exempt sales represent 0.655 percent of reported taxable sales.