

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:)
EARTH-N-WARE, INC.) Account Number: SR EA 24-969442
Petitioner) Case ID 459938
Orange, Orange County

Type of Business: Cigarette store
Audit period: 01/01/05 – 12/31/07

<u>Item</u>	<u>Disputed Amount</u>		
Disallowed claimed exempt sales	\$4,072,455		
Unreported cigarette rebates	\$ 182,383 ¹		
Negligence penalty	\$ 32,975		
		<u>Tax</u>	<u>Penalty</u>
As determined and protested:		<u>\$329,749.98</u>	<u>\$32,975.02</u>
Proposed tax redetermination		\$329,749.98	
Interest through 3/31/11		134,704.55	
Negligence penalty		<u>32,975.02</u>	
Total tax, interest, and penalty		<u>\$497,429.55</u>	
Monthly interest beginning 4/1/11		<u>\$ 1,923.54</u>	

UNRESOLVED ISSUES

Issue 1: Whether the claimed exempt sales in interstate commerce were properly disallowed.

We find that they were.

Petitioner operates a cigarette store. During its preliminary examination, the Sales and Use Tax Department (Department) found that petitioner's various records substantially reconciled. The Department noted that petitioner had claimed exempt sales in interstate commerce in excess of

¹ Of this amount, the audit allocates \$18,984 to cigarette rebates related to reported taxable sales and \$163,399 to rebates related to disallowed claimed exempt sales in interstate commerce. However, this allocation is not relevant here because petitioner has not argued that any portion of the rebates were not subject to tax because they were paid with respect to exempt interstate sales, and, for the reasons explain in our discussion under Issue 1, we would reject that argument if raised because we conclude that petitioner has not established that any of the claimed exempt sales were, in fact, exempt.

1 \$4 million to one customer, B&T Services, Inc. (B&T). However, petitioner was unable to produce
2 any shipping documents to support the claimed interstate sales. Petitioner stated that there were no
3 shipping documents because it delivered the cigarettes to B&T in Nevada each week. Petitioner
4 further asserted that it had no receipts from the trips because it transported the cigarettes using a van
5 with a large gas tank and thus never had to stop for gasoline or anything else during the approximate
6 five-hour round-trip drive from California to Nevada. The Department found there was insufficient
7 evidence to show that the claimed amounts were, in fact, exempt sales in interstate commerce, and it
8 disallowed the entire amount claimed during the audit period.

9 Petitioner contends that the claimed interstate sales represented valid exempt sales and should
10 not have been disallowed. Petitioner states that all its sales to B&T were sales of cigarettes that
11 petitioner delivered to Nevada. Petitioner further states that it sold only 45-50 cartons of cigarettes per
12 week from its store in California and could not have sold over 700 cartons of cigarettes a week from
13 that location.

14 At the appeals conference, petitioner indicated that it decided to change its business from
15 pottery sales to cigarette sales largely because of discussions with B&T. The theory of the revised
16 business model, petitioner says, was that B&T would be petitioner's primary customer. Petitioner
17 states that it delivered 500 to 800 cartons of cigarettes each week to B&T in Nevada, in exchange for a
18 payment of \$10,000 (with additional amounts, if any, paid the following week). Petitioner asserts it
19 then deposited large amounts of cash into the bank each Monday. According to petitioner, these
20 transactions occurred every Saturday night for approximately 15 years, until B&T learned petitioner
21 was being audited and cut off all contact with petitioner. To support its contentions, petitioner
22 provided four bank statements which show large deposits (greater than \$10,000) each Monday,
23 claiming that the deposits are evidence of large weekly sales to B&T. Petitioner also provided two
24 invoices dated January 6 and 13, 2007, which show sales of cigarettes to B&T, with delivery occurring
25 in Primm, Nevada. Although the invoices include a signature line for the customer, neither invoice is
26 signed. In addition, petitioner provided an undated letter from the corporate president, Suzanne
27 Newton, stating that she recalls that her husband, Gerald Newton, was gone every Saturday night,
28 presumably making cigarette deliveries.

1 Petitioner’s evidence simply is not plausible. The large deposits each Monday morning may be
2 evidence of significant sales over the weekend, but they have no evidentiary value with regard to the
3 identity of the customers or the place of sale. We find the invoices unconvincing, first because they
4 are unsigned, and second because petitioner has provided only two invoices despite claiming to have
5 made deliveries to B&T every week for 15 years. Further, we find that the letter from Ms. Newton
6 does not even state that she observed any deliveries of cigarettes to B&T in Nevada. Accordingly, we
7 conclude that the evidence provided by petitioner is insufficient to show that the amounts claimed on
8 returns represented valid exempt sales in interstate commerce (or sales outside California).² With
9 respect to petitioner’s statement that it could not have sold over 700 cartons of cigarettes a week out of
10 its store, we note petitioner asserted at the appeals conference that its sales from the store had increased
11 from the 50 cartons of cigarettes per week during the audit period to 300 per week at the time of the
12 appeals conference. Petitioner’s only explanation for this increase was word-of-mouth advertising.
13 We find it very unlikely that there was such a dramatic increase in sales based solely on word-of-
14 mouth, with such increase occurring solely after the audit period and after petitioner’s alleged
15 relationship with B&T had ended. We find that petitioner has not supported its claimed exempt sales
16 in interstate commerce and that no adjustment is warranted to the disallowed claimed exempt sales.

17 **Issue 2:** Whether adjustments are warranted to the unreported cigarette rebates. We
18 recommend no adjustment.

19 The Department found that the gross receipts reported on petitioner’s income tax returns
20 substantially reconciled with the total sales reported on its sales and use tax returns. On the income tax
21 returns, however, the Department noted that petitioner had separately reported rebate income as “other
22 income.” The Department therefore concluded that cigarette rebates were not included in the sales
23 petitioner reported on sales and use tax returns. From petitioner’s records, the Department established
24 total cigarette rebates for the audit period of \$182,383, all of which it treated as taxable.

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27 ² The D&R also considers whether the sales to B&T were nontaxable sales for resale, although petitioner did not raise that
28 contention. The Department has been unable to find any business information about B&T, and there is no dispute that B&T
did not provide petitioner a resale certificate. Thus, the Department concluded the sales were not nontaxable sales for
resale, and we concur.

1 The rebates at issue were issued by the cigarette manufacturers rather than petitioner's
2 distributors, and they constitute gross receipts to petitioner. Accordingly, they are subject to tax, and
3 petitioner does not argue otherwise. Instead, petitioner contends that it has already paid tax with
4 respect to the cigarette rebates. As support, petitioner has provided pricing sheets, asserting that those
5 sheets show petitioner charged tax reimbursement to its customers on cigarette selling prices that
6 included the rebates.

7 We find that the pricing sheets alone are not proof that tax was properly remitted on the
8 manufacturer's rebates. As noted previously, the total sales reported for sales and use tax purposes
9 reconciled with the gross receipts reported on income tax returns, and the rebates were reported on the
10 income tax returns as other income *in addition* to gross receipts. Thus, it is clear that the rebates were
11 not included in the total sales reported on sales and use tax returns, and we recommend no adjustment.

12 **Issue 3:** Whether petitioner was negligent. We conclude that it was.

13 The Department imposed the 10-percent penalty for negligence because petitioner failed to
14 maintain any records or documentation supporting the claimed deductions for exempt interstate sales
15 in excess of \$4 million, which represented nearly 90 percent of its total sales. Petitioner disputes the
16 penalty on the basis that it maintained accurate records and made no attempt to deceive the Board or
17 conceal its interstate commerce sales during the audit.

18 Petitioner's corporate officers have significant business experience in this industry and should
19 have been well aware of the recordkeeping requirements. Nevertheless, petitioner kept virtually no
20 records to support the claimed exempt sales in interstate commerce (not even sales invoices, and no
21 records of delivery outside the state). Also, the understatement of reported taxable sales of \$4,254,838
22 represents an error ratio of 898 percent. We find that the substantial error and the absence of records to
23 support claimed exempt sales are evidence that petitioner was negligent, at least. Thus, we find the
24 penalty was properly applied.

25 OTHER DEVELOPMENTS

26 None.

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