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:	
KHN, INC., dba 13th Street Market	Account Number SR FH 100-375826 Case ID 457530
Petitioner	Imperial Beach, San Diego County

Type of Business: Liquor store

Audit period: 07/01/04 – 06/30/07

Item	Disputed Amount
Understatement of reported taxable sales	$151,881

	Tax	Penalty
As determined and proposed to be redetermined	$12,049.81	$1,205.02
Less concurred	- 279.00	-1,205.02
Balance, protested	$11,770.81	$ 00.00
Proposed tax redetermination	$12,049.81	
Interest through 04/30/13	6,503.00	
Negligence penalty	1,205.02	
Total tax, interest, and penalty	$19,757.83	
Monthly interest beginning 05/01/13	$ 60.25	

This matter was scheduled for Board hearing in April 2012, but was postponed for settlement consideration. It was rescheduled for Board hearing in February 2013, but was postponed at petitioner's request due to a scheduling conflict.

UNRESOLVED ISSUE

Issue: Whether adjustments are warranted to the audited understatement of reported taxable sales. We find no adjustment is warranted.

Petitioner has operated a liquor store since March 2004. For audit, petitioner provided federal income tax returns, income statements, purchase invoices, monthly sales worksheets, and copies of sales and use tax returns.

The Sales and Use Tax Department (Department) found that total sales reported on sales and use tax returns substantially reconciled with amounts recorded on petitioner's income statements. However, the Department computed that recorded costs exceeded sales for the last two quarters of 2004, and the book markups for the remainder of the audit period ranged from 0.42 percent to 12.38 percent, which were much lower than the range of markups the Department expected (30 to 40 percent). The Department decided to establish taxable sales on a markup basis.

To establish audited costs of goods sold, the Department used recorded purchases, adjusted for changes in inventory, based on records of inventory counts by a third-party inventory service. For the majority of the period, July 1, 2004, through December 31, 2006, petitioner segregated its taxable and nontaxable purchases in its records, and the percentage of taxable to total purchases was 90.18 percent. The Department used the recorded taxable merchandise purchase ratio to establish audited taxable purchases for the first two quarters of 2007 and to establish the portion of the inventory adjustments that represented taxable goods. The Department then made adjustments for an estimated cost of self-consumed taxable merchandise of $300 per quarter and for pilferage losses, estimated at 1 percent, to establish audited costs of taxable merchandise sold. Based on shelf tests for various merchandise categories and the ratios of purchases in each merchandise category, as established in a purchase segregation test, the Department calculated a weighted average markup of 23.71 percent. The Department added the weighted average markup to audited costs of taxable merchandise sold to establish audited taxable sales, which exceeded reported taxable sales by $151,881 for the audit period.

Petitioner contends that the audited understatement of reported taxable sales is excessive, arguing that the audited percentage of taxable to total merchandise purchases should be reduced by 2 percent, based on petitioner's purchase segregation test for 2009. Petitioner also argues that the inventory adjustment for the first six months of 2007 should be increased since the latest inventory count was dated March 12, 2007, a few months before the end of the audit period, June 30, 2007. Petitioner asserts that the inventory increased further during the period March 13, 2007, through June 30, 2007, and it has computed that purported increase to be $28,471.

Regarding petitioner's assertion that the audited percentage of taxable to total purchases should be reduced, we note that the audited percentage is based on petitioner's own records for 10 of the 12 calendar quarters of the audit period. In contrast, the purchase segregation test provided by petitioner at the appeals conference is based on purchases made in 2009, one-and-a-half years after the end of the audit period. There is no evidence that the recorded purchases made long after the audit period are more accurate or more representative of petitioner's purchasing patterns than the amounts recorded in petitioner's own records for the period under review. Accordingly, we find no adjustment is warranted to the percentage of taxable to total purchases. Regarding petitioner's claim that the amount of ending inventory should be increased, we find that it was appropriate for the Department to utilize the inventory counts provided by petitioner, since those counts had been recorded by a third-party inventory service. We find petitioner's computations do not represent persuasive evidence that the inventory increased markedly from March 12, 2007, through June 30, 2007, and we recommend no adjustment.

RESOLVED ISSUES

In its petition for redetermination, petitioner protested the entire liability. However, at the appeals conference, petitioner stated that it does not protest the tax applicable to the cost of self-consumed taxable merchandise of $3,600 and does not protest the negligence penalty. Accordingly, those two issues have been resolved.

OTHER MATTERS

None.

Summary prepared by Lisa Burke, Business Taxes Specialist III

MARKUP TABLE

Percentage of taxable vs. nontaxable purchases	90.18%
Mark-up percentages developed	23.71%
Self-consumption allowed in dollars	$1,200 per year
Self-consumption allowed as a percent of taxable purchases	0.22%
Pilferage allowed in dollars	$16,557
Pilferage allowed as a percent of taxable purchases	1%