

CALIFORNIA STATE BOARD OF EQUALIZATION
APPEALS DIVISION SUMMARY FOR BOARD HEARING

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3 In the Matter of the Petition for Redetermination)
4 Under the Sales and Use Tax Law of:)
5 BORIS KHODZHONYAN, dba House of Liquor) Account Number: SR AP 99-756257
6) Case ID 405900
7 Petitioner) Glendale, Los Angeles County

8 Type of Business: Liquor store

9 Audit period: 01/01/03 – 12/31/05

<u>Item</u>	<u>Disputed Amount</u>		
11 Unreported taxable sales	\$2,126,937		
12 Negligence penalty	\$ 17,584		
		<u>Tax</u>	<u>Penalty</u>
13 As determined and proposed to be redetermined:		\$175,842.63	\$17,584.31
14 Less concurred		- 370.26	0.00
Balance, protested		<u>\$175,472.37</u>	<u>\$17,584.31</u>
15 Proposed tax redetermination		\$175,842.63	
16 Interest through 6/30/11		99,439.19	
Negligence penalty		<u>17,584.31</u>	
17 Total tax, interest, and penalty		\$292,866.13	
Payments		- 164.26	
18 Balance Due		<u>\$292,701.87</u>	
19 Monthly interest beginning 7/1/11		<u>\$ 878.39</u>	

20 A Notice of Appeals Conference was mailed to petitioner's address of record, with a copy to
21 his representative, and neither notice was returned by the Post Office. Neither petitioner nor his
22 representative responded or appeared at the appeals conference, which was held as scheduled. We
23 thereafter sent a letter to petitioner, with a copy to his representative, offering the opportunity to
24 provide any additional arguments and evidence in writing it wished us to consider. Petitioner
25 contacted us by telephone, stating he had no additional evidence or arguments to present.

26 This matter was scheduled for Board hearing on October 28, 2008, but was postponed for
27 settlement consideration. It was rescheduled for Board hearing on October 20, 2010, and again on
28 March 24, 2011, but was postponed each time to allow petitioner's representative additional time to

1 prepare for the hearing.

2 UNRESOLVED ISSUES

3 **Issue 1:** Whether adjustments are warranted to the unreported taxable sales established on a
4 markup basis. We recommend no adjustment.

5 Petitioner operates a liquor store. During the audit, he stated that reported sales were based on
6 cash register z-tapes, but he did not provide cash register tapes for audit. The Department decided to
7 use the markup method to establish audited taxable sales. Based on information from 14 of
8 petitioner's vendors, the Department compiled petitioner's purchases of taxable merchandise during
9 the audit period which it reduced by \$8,084 to account for changes in inventory and by \$4,488 for self-
10 consumption (about \$125 per month), and then by one percent for pilferage to establish audited cost of
11 taxable goods sold of \$2,451,550 for the audit period. The Department used costs from purchase
12 invoices and selling prices provided orally by petitioner to compute an audited markup of 13.06
13 percent, which it applied to audited cost of goods sold to establish audited taxable sales of \$2,729,934.
14 Since petitioner reported taxable sales of \$603,009 for the audit period, the Department established an
15 understatement of \$2,126,925, representing an error ratio of 352.7 percent.

16 Petitioner contends that the amount of unreported taxable sales is excessive because the audited
17 markup is too high and because the purchase information obtained from his vendors is inaccurate. The
18 Department used known merchandise costs to establish audited taxable sales. Thus, we conclude that
19 the cost of taxable goods sold was not less than the audited taxable cost of goods sold.¹ We note that,
20 had petitioner sold its taxable goods at cost, the deficiency would still be over \$1.8 million, for an error
21 rate of about 300 percent. That is, most of the measure of deficiency is the difference between cost of
22 taxable goods sold and reported taxable sales, regardless of the amount of the markup. Regarding the
23 markup, the Department accepted petitioner's oral statement of his prices without verification, and
24 used those prices to establish a markup of 13.06 percent. Based on our experience reviewing audits of
25 similar businesses, we would expect the markup to be considerably higher, in the range of 25 to 40

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27 ¹ If petitioner made purchases from vendors other than the 14 for which the Department obtained purchase information, the
28 cost of taxable goods sold could have been greater than the audited cost of taxable goods sold.

1 percent. Thus, by using the prices provided by petitioner without verification, we believe that the
2 Department was very lenient with petitioner in establishing the markup.² Petitioner has provided no
3 documentation to support a reduction to the cost of taxable goods sold or to the markup, and we thus
4 find that no adjustment to the deficiency is warranted.

5 **Issue 2:** Whether any of petitioner's sales were exempt sales in foreign commerce. We find
6 that no sales were exempt.

7 Petitioner claims that the audited amount of unreported taxable sales should be reduced for
8 exempt sales in foreign commerce made during the third quarter 2004 and fourth quarter 2005, which
9 he did not claim as exempt sales on his sales and use tax returns.³ As support, petitioner has provided
10 three invoices for sales to Vladimiry Vasilenko. Petitioner states that Mr. Vasilenko picked up the
11 merchandise at petitioner's store and then exported the property to Russia. Even if the sales occurred
12 as alleged, they would not have qualified as exempt sales in foreign commerce since, as petitioner
13 concedes, he delivered the property to the purchaser in this state and the property was not irrevocably
14 committed to the export process at the time of sale.

15 **Issue 3:** Whether petitioner was negligent. We conclude that he was.

16 The Department imposed the 10-percent penalty for negligence because petitioner's records
17 were inadequate for sales and use tax purposes and the amount of understatement is substantial.
18 Petitioner has not specifically disputed the negligence penalty.

19 Petitioner provided incomplete records for audit. The percentage of petitioner's reported
20 taxable to total sales was only 36 percent, even though petitioner knew (or should have known) that
21 most of his sales were taxable. The audited amount of unreported taxable sales of \$2,126,937 and the
22 error rate of over 350 percent are both substantial. We find these facts evidence petitioner's failure to
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24 ² The Department did not have the benefit of cash register tapes or copies of advertisements from the audit period.
25 However, since the business is on-going, it could have compared petitioner's markup for selected items at the time the audit
26 to the markup for those items based on the prices given by petitioner to see if the markups were generally in the same
27 range, which we would expect unless petitioner's business model had changed since the audit period (which we are not
28 aware of). In any event, we would be surprised if such a comparison would have resulted in an even lower markup than
used by the Department.

³ Although petitioner claimed a deduction for exempt sales in interstate and foreign commerce on his second quarter 2004
return, that deduction should have been claimed for nontaxable sales of food. Petitioner does not assert that there were any
exempt sales in interstate or foreign commerce for the second quarter.

1 exercise due care in recording or reporting. We conclude that, at a minimum, the understatement was
2 the result of negligence and the penalty properly applied.

3 **OTHER DEVELOPMENTS**

4 None.

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6 Summary prepared by Thea Etheridge, Business Taxes Specialist II
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MARKUP TABLE

Percentage of taxable vs. nontaxable purchases	96%*
Mark-up percentage developed	13.06%
Self-consumption allowed in dollars	\$1,496 per year
Self-consumption allowed as a percent of total purchases	0.18%
Pilferage allowed in dollars	\$24,390 for the audit period
Pilferage allowed as a percent of total purchases	1%

* This is the percentage computed in the Department's preliminary review of the records, using the available purchase invoices for the 1Q05. In the detailed markup computations, the Department used purchases of taxable merchandise, provided by petitioner's vendors, and it did not compile the purchases of food products or compute a percentage of taxable to total purchases.