STATE BOARD OF EQUALIZATION
SALES AND USE TAX APPEAL

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: BORIS KHODZHOYAN, dba House of Liquor Petitioner	Account Number: SR AP 99-756257 Case ID 405900 Glendale, Los Angeles County

Type of Business: Liquor store

Audit period: 01/01/03 – 12/31/05

Item	Disputed Amount
Unreported taxable sales	$2,126,937
Negligence penalty	$ 17,584

	Tax	Penalty
As determined and proposed to be redetermined:	$175,842.63	$17,584.31
Less concurred	- 370.26	00.00
Balance, protested	$175,472.37	$17,584.31
Proposed tax redetermination	$175,842.63	
Interest through 10/31/10	91,240.87	
Negligence penalty	17,584.31	
Total tax, interest, and penalty	$284,667.81	
Payments	- 164.26	
Balance Due	$284,503.55	
Monthly interest beginning 11/1/10	$ 1,024.79	

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

This matter was previously scheduled for Board hearing on October 28, 2008, but was postponed for settlement consideration.

UNRESOLVED ISSUES

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

Petitioner operates a liquor store. During the audit, he stated that reported sales were based on cash register z-tapes, but he did not provide cash register tapes for audit. Upon review of the available purchase invoices, the Sales and Use Tax Department (Department) ascertained that about 96 percent of petitioner's purchases were goods whose retail sales are taxable and only about 4 percent of petitioner's purchases were food products whose retail sales are exempt from tax. Despite these purchases, however, the Department noted that petitioner reported only about 36 percent of his total sales as taxable. Further, in its preliminary review of the records, the Department found that the cost of taxable goods sold (computed using 96 percent of the cost of goods sold reported on federal income tax returns) substantially exceeded reported taxable sales. Based on these discrepancies, the Department concluded further investigation was warranted and decided to establish audited taxable sales on a markup basis.

To establish audited purchases of taxable merchandise, the Department obtained information regarding petitioner's purchases from 14 of his vendors. To establish the audited cost of taxable goods sold, the Department reduced the total amount of purchases by $8,084 to account for changes in inventory, and reduced the remainder by an estimated cost of self-consumed merchandise of $4,488 (about $125 per month) and by one percent for pilferage. The Department then prepared a shelf test, using costs from purchase invoices and selling prices provided orally by petitioner, to compute an audited markup of 13.06 percent. Using that markup and the audited cost of taxable goods sold, the Department established audited taxable sales of $2,729,934, which exceeded reported taxable sales of $603,009 by about 353 percent.

Petitioner contends that the amount of unreported taxable sales is excessive because the audited markup is too high and because the purchase information obtained from his vendors is inaccurate. The Department used known merchandise costs from purchase invoices and selling prices provided by petitioner to establish the audited markup, and petitioner has not provided any documentation to show that the selling prices he provided were excessive. Further, based on our experience reviewing audits

of similar businesses, we would expect the markup to be in the range of 25 to 40 percent, much higher than the audited markup of 13.06 percent. Considering that the Department had no way to verify the accuracy of the selling prices provided by petitioner (e.g., prices posted on the shelves, cash register tapes, or copies of advertisements) and that the result of these purported selling prices was a markup considerably lower than we would have expected, we believe that the Department was very lenient with petitioner in establishing the markup. In the absence of documentation supporting an adjustment, we find that no adjustment to reduce the audited markup is warranted. We similarly reject petitioner's unsupported contention that the purchase information provided by vendors is inaccurate, especially considering that petitioner failed to provide a purchase journal for audit, and the purchase invoices that he did provide were incomplete. We find that the best information available regarding petitioner's merchandise purchases is the information from the vendors, and we recommend no adjustments.

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

Petitioner claims that the audited amount of unreported taxable sales should be reduced for exempt sales in foreign commerce made during the third quarter 2004 (3Q04) and 4Q05, which he did not claim as exempt sales on his sales and use tax returns.[1] As support, petitioner has provided three invoices for sales to Vladimiry Vasilenko. Petitioner states that Mr. Vasilenko picked up the merchandise at petitioner's store and then exported the property to Russia.

For the reasons set forth in the D&R, we find that the evidence does not support that petitioner actually made the three sales to Mr. Vasilenko alleged to be represented by the sales invoices petitioner provided. In any event, even if the sales occurred as alleged, they would not have qualified as exempt sales in foreign commerce because petitioner delivered the property to the purchaser in this state and the property was not irrevocably committed to the export process at the time of sale.[2]

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

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[1] Although petitioner claimed a deduction for exempt sales in interstate and foreign commerce on his 2Q04 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.

[2] Since we conclude that the invoices did not represent actual sales, we did not reach the question of whether the alleged sales might have been for resale.

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

Petitioner provided incomplete records for audit, and the amounts of purchases claimed on federal income tax returns for 2003 and 2004, combined, were $777,506, which is significantly less than the $1,310,715 compiled by the Department for those two years. In addition, the percentage of petitioner's reported taxable to total sales was only 36 percent, even though petitioner knew (or should have known) that most of his sales were taxable. Moreover, the audited amount of unreported taxable sales of $2,126,937, which represents an understatement of over 350 percent, is substantial both as an absolute value and in relation to reported amounts. We find that the significant understatement of recorded purchases, the unusually low percentage of reported taxable to total sales, and the substantial understatement are evidence that petitioner did not exercise due care in recording or reporting. We conclude the understatement was the result of negligence, at a minimum, and the penalty was properly applied.

OTHER DEVELOPMENTS

None.

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

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.