

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:)
MAHERALI, INC., dba Bob's Tiny Mart) Account Number: SR KHO 97-612777
Case ID 343758
Petitioner) Porterville, Tulare County

Type of Business: Gas station with mini-mart

Audit period: 04/01/02 – 03/31/05

<u>Item</u>	<u>Disputed Amount</u>	
Unreported taxable sales	\$137,719	
Amnesty interest penalty	\$ 819	
	<u>Tax</u>	<u>Penalty</u>
As determined	\$16,499.15	\$2,690.49
Adjustment: Appeals Division	<u>- 3,777.99</u>	<u>- 2,690.49</u>
Proposed redetermination	\$12,721.16	<u>00.00</u>
Less concurred	<u>- 2,934.54</u>	
Balance, protested	<u>\$ 9,786.62¹</u>	
Proposed tax redetermination	\$12,721.16	
Interest through 6/30/10	8,089.80	
Amnesty interest penalty	<u>819.03</u>	
Total tax, interest, and penalty	\$21,629.99	
Payments	<u>-405.00</u>	
Balance Due	<u>\$21,224.99</u>	
Monthly interest beginning 7/1/10	<u>\$ 71.84</u>	

This matter was scheduled for Board hearing on February 23, 2010, but petitioner did not respond to the Notice of Hearing. Accordingly, the Board Proceedings Division informed petitioner that this matter would be presented to the Board for decision without oral hearing. Subsequently, petitioner responded and requested an oral hearing before the Board.

¹ The amount of understated tax established in the reaudit is \$12,919.16, less a credit for unclaimed prepayments of sales tax to vendors of \$198.00. Petitioner concurs with the credit. Accordingly, the total amount of tax understatement disputed is \$9,984.62 (\$9,786.62 + \$198.00).

UNRESOLVED ISSUE

Issue: Whether further adjustments are warranted. We recommend no further adjustments.

Petitioner has operated a gas station and mini-mart since October 1999. During the present audit, the Sales and Use Tax Department (Department) found several inconsistencies in petitioner's records. After further investigation, the Department concluded that petitioner's recorded and reported sales of gasoline were substantially accurate and decided to establish audited taxable mini-mart sales on a markup basis. The Department combined a segregation test it conducted with one provided by petitioner to compute that 73.79 percent of petitioner's purchases represented taxable merchandise. To establish audited purchases of taxable merchandise, the Department applied that percentage to recorded mini-mart purchases, after reducing the purchases for 2004 by an inventory adjustment of \$39,357. The Department then deducted an estimated loss due to pilferage, computed at 2 percent, and an estimated cost of self-consumed taxable merchandise of \$525 per month to establish the audited cost of taxable goods sold. The Department added the audited markup of 28.817 percent, established in a shelf test, to establish audited taxable mini-mart sales, which it added to recorded fuel sales and recorded sales of hot food to establish audited taxable sales.

The audited deficiency was measured by \$230,305, consisting of an understatement of reported taxable sales of \$211,405 and unreported taxable self-consumption of \$18,900. After the appeals conference, petitioner provided sales records for the entire audit period, based on which the Department prepared schedules to show the following proposed adjustments: a reduction in the understatement of reported taxable sales established on a markup basis of \$95,966, from \$211,405 to \$115,439; the addition of a separate understatement of \$13,618 for a difference between recorded and reported taxable sales for the first quarter 2005; and a reduction to unreported taxable self-consumption of \$7,875, from \$18,900 to \$11,025. Thus, the Department's schedules reflect a proposed reduction in the measure of deficiency of \$90,223, from \$230,305 to \$140,082.

Petitioner contends that the audited understatement should be limited to the difference between recorded and reported taxable sales. Petitioner asserts that the markup audit approach is arbitrary and should not be used since petitioner has now provided sales records for the audit period. Nevertheless, petitioner expressed to the Department that it would accept use of the markup audit approach for the

1 period April 1, 2002, through December 31, 2002, since it concedes that there was a significant
2 understatement of recorded and reported taxable sales for 2002. However, if audited sales for 2002 are
3 established on a markup basis, petitioner contends that the inventory adjustment of \$39,357 should be
4 used to compute the audited cost of taxable goods sold for 2002 rather than 2004. Then, petitioner
5 contends that recorded taxable sales for the period January 1, 2003, through March 31, 2005, should be
6 considered substantially accurate.

7 The markup method is a recognized and standard audit procedure which was warranted in this
8 case because of inconsistencies in petitioner's records. Further, the Department made generous
9 adjustments in establishing the audited cost of taxable sales. First, it made an adjustment for an
10 increase in inventory of \$39,357 based solely on its observation that there was a significant amount of
11 inventory in a back room, which appeared to have been sitting for a long period. However, not only
12 was there no evidence showing that the inventory in the back room had been purchased during the
13 audit period, but also, using the amounts recorded on petitioner's income tax returns (which were not
14 documented by detailed inventories taken at any time during the audit period), the increase in
15 inventory over the audit period would have been only \$4,846. The Department also made allowances
16 for pilferage and self-consumption that exceed the minimum amounts set forth in the Board's Audit
17 Manual. With respect to the allowance for self-consumed merchandise, we note that the Department
18 accepted petitioner's estimate of \$525 per month, an amount significantly higher than the estimated
19 costs of self-consumed merchandise that are routinely allowed in markup audits of this nature without
20 documentation, based only on petitioner's undocumented estimate. Further, we note that petitioner's
21 estimated self-consumption included fuel, and since the Department accepted recorded taxable sales of
22 fuel as substantially accurate, any cost of self-consumed fuel should not have been deducted from
23 audited taxable mini-mart purchases in the markup computations. We find that the Department's
24 allowance for self-consumption is generous. In summary, we find that the only possible errors in the
25 audit favor petitioner.

26 The Department's post-conference schedules reflect a credit measure of \$22,280 for 2003,
27 which represents an overpayment of about 1.9 percent of reported taxable sales. We find that this
28 small difference is the result of variances in the markup audit approach, in particular the generous

1 allowances for pilferage and self-consumption. We simply do not believe that petitioner over-reported
2 its sales. Accordingly, we recommend that reported taxable sales be accepted for 2003 and that the
3 Department's proposed credit measure of \$22,280 be eliminated (which still results in a reduction to
4 the measure of deficiency included in the Notice of Determination for 2003 from \$7,473 to zero).

5 With respect to the year 2004, we concur with the Department's conclusion that recorded taxable sales
6 are substantially accurate. We have compared recorded and reported taxable sales for 2004, and we
7 find there is no difference between recorded and reported taxable sales for the fourth quarter 2004, and
8 there are positive and negative differences in the first and second quarters of 2004 that essentially
9 offset one another. However, for the third quarter 2004, recorded taxable sales exceed the reported
10 amount by \$7,958. Based on our conclusion that recorded taxable sales for 2004 are substantially
11 correct, we find that this difference between recorded and reported taxable sales represents an
12 understatement that the Department did not identify. Thus, adding this understatement to the \$13,618
13 difference the Department identified for the first quarter 2005, the total measure of deficiency for the
14 difference between recorded and reported sales should be \$21,576.

15 With respect to petitioner's contention that the inventory increase should be deducted from the
16 audited cost of taxable mini-mart sales for 2002 rather than 2004, we disagree. Petitioner has provided
17 no evidence that the allowed amount of inventory increase occurred in 2002 rather 2004. In fact, as
18 noted above, there is no evidence that the increase even occurred during the audit period. Moreover, if
19 the inventory adjustment were eliminated from the calculations for 2004, then the resulting markup for
20 that year would be only 15.8 percent, which we believe is too low. As such, if the inventory
21 adjustment were moved from 2004 to 2002, we would find that the low markup indicates an
22 understatement and would thus conclude that taxable sales for 2004 should be established on a markup
23 basis. We recommend no adjustments based on petitioner's contention that the inventory adjustment
24 should be made in the markup computations for 2002.

25 With respect to the audited cost of self-consumed merchandise of \$525 per month which was
26 based solely on petitioner's undocumented estimate, although petitioner did not protest this item, in its
27 post-conference schedules, the Department proposed that the measure of deficiency of \$7,875 for the
28 period January 1, 2004, through March 31, 2005, be deleted. The Department did not specifically

1 explain its reasoning for this adjustment. However, it apparently concluded that, since it was
2 eliminating the understatement established on markup basis for this period, it should also delete the
3 assessment of use tax on the cost of self-consumed taxable merchandise, which was one element of the
4 markup computations.

5 We find that no adjustment of the audited cost of self-consumed merchandise is warranted.
6 The Department's basis for accepting recorded sales for 2004 as substantially accurate is that a
7 comparison of the recorded cost of taxable mini-mart sales to reported taxable sales results in a markup
8 for that year of 26.8 percent, and this markup is reasonably similar to the markup of 28.817 percent
9 computed in the shelf test. However, the recorded cost of taxable mini-mart sales the Department used
10 for this computation was *net* of an estimated cost of self-consumed merchandise of \$6,300 (that is, the
11 same \$525 per month self-consumption applied throughout the audit period). Thus, the Department's
12 markup computations are based on its conclusion that petitioner withdrew taxable merchandise from
13 inventory for its own use, at a cost of \$525 per month, throughout the audit period. Petitioner reported
14 no purchases subject to use tax during the audit period. Therefore, it owes use tax on the cost of
15 merchandise self-consumed during the period for which the Department has accepted recorded taxable
16 sales as substantially accurate.

17 In summary, we recommend a reduction to the audited understatement of reported taxable sales
18 established on a markup basis of \$73,686, from \$211,405 to \$137,719, and establishing a separate
19 audit item for the difference between recorded and reported taxable sales of \$21,576. We also
20 recommend no adjustment to the audited cost of self-consumed taxable merchandise of \$18,900. Thus,
21 we recommend a total reduction of the audited taxable measure of \$52,110, from \$230,305 to
22 \$178,195.

23 AMNESTY

24 Petitioner did not participate in the amnesty program, and an amnesty interest penalty of
25 \$819.03 will be added when this liability becomes final. We explained in a letter to petitioner that
26 petitioner could request relief of the penalty, and provided petitioner a form it could use to do so.
27 Petitioner has not submitted a request for relief, signed under penalty of perjury. Thus, we have no
28 basis upon which to consider whether relief of the amnesty interest penalty is warranted

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RESOLVED ISSUE

Prior to the appeals conference, the Department recommended that the negligence penalty and amnesty double negligence penalty be deleted because this was the first audit of petitioner, and petitioner's reporting had improved markedly after 2002.

OTHER DEVELOPMENTS

None.

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

MARKUP TABLE

Percentage of taxable vs. nontaxable purchases	73.79%
Mark-up percentages developed	28.82%
Self-consumption allowed in dollars	6,300 per year
Self-consumption allowed as a percent of total purchases	1.28%
Pilferage allowed in dollars	\$9,838
Pilferage allowed as a percent of total purchases	2%