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:	
MAGDI SHAWKI MAHFOUZ, dba AM/PM 3041	Account Number: SR Y AA 99-675043 Case ID 488819
Petitioner	Lakewood, Los Angeles County

Type of Business: Gas station with mini-mart

Audit period: 01/01/05 – 12/31/07

Item	Disputed Amount
Unreported sales	$3,222,661
Negligence penalty	$ 42,684

	Tax	Penalty
As determined and proposed to be redetermined	$426,836.49	$42,683.66
Less concurred	- 160,966.92	00.00
Balance, protested	$265,869.57	$42,683.66

Proposed tax redetermination	$426,836.49
Interest through 10/31/11	177,052.43
Negligence penalty	42,683.66
Total tax, interest, and penalty	$ 646,572.58
Payments	- 4,000.00
Balance Due	$ 642,572.58
Monthly interest beginning 11/1/11	$ 2,114.18

This matter was scheduled for Board hearing in July 2011, but was rescheduled to Culver City at petitioner's request.

UNRESOLVED ISSUES

Issue 1: Whether adjustments are warranted to the amount of unreported sales. We find no adjustment is warranted.

Petitioner operates two gasoline stations with mini-marts. For audit, petitioner provided federal income tax returns and AM/PM franchise history sales reports for one location for the period February 1, 2007, through January 31, 2008.

The Sales and Use Tax Department (Department) compared gross receipts reported on federal returns with total sales reported on sales and use tax returns and found differences of $1,217.917 for

2005, $1,368,638 for 2006 and $2,587,220 for 2007. Based on gross receipts and cost of sales reported on the federal returns, the Department computed book markups of 3.09 percent for 2006 and 3.89 percent for 2007 with lotto sales, and 3.21 percent for 2006 and 4.00 percent for 2007 excluding lotto sales. Although these markups appear low for a gas station and mini-mart, the Department noted that ARCO gas stations usually have lower prices than other gas stations. Therefore, the Department decided that the amounts of gross receipts reported on federal returns were substantially accurate. The Department then used the AM/PM sales reports for the period February 1, 2007, through December 31, 2007, to compute that exempt mini-mart sales and lotto sales represented 3.41 percent and 2.50 percent, respectively, of total sales. The Department applied those percentages to gross receipts reported on the federal return for 2007 to compute exempt sales of food products of $652,169 and nontaxable lotto sales of $478,254 for 2007, which were reasonably similar to the amounts claimed on sales and use tax returns of $612,261 and $481,689, respectively. Therefore, the Department concluded that petitioner's claimed amounts of exempt food sales and nontaxable lotto sales were substantially accurate. To establish audited taxable sales for each year, the Department reduced the gross receipts reported on petitioner's federal returns by the amounts of exempt food sales and nontaxable lotto sales claimed on sales and use tax returns. It compared audited and reported taxable sales to compute understatements resulting in percentages of error of 11.76 percent for 2005, 12.12 percent for 2006, and 16.73 percent for 2007. The Department applied those percentages to reported taxable sales by quarter to compute the unreported taxable sales of $5,173,775.

Petitioner contends that the audited amount of taxable sales is overstated because the gross receipts reported on the federal returns included sales tax reimbursement, and that his actual understatement is $1,951,114. Petitioner provided a worksheet showing his calculations and a handwritten schedule that appeared to be a sales and use tax return worksheet for the second quarter 2005, supported by a computerized quarterly AM/PM sales report for each station.

Petitioner has provided no documentation to show that the gross receipts reported on his federal returns included sales tax reimbursement, nor is his assertion that tax reimbursement was included supported by the records he provided for the second quarter 2005. For that quarter, the AM/PM sales reports reflected taxable sales of $3,035,293, although petitioner recorded taxable sales of $2,735,293 on the sales and use tax return worksheet (and reported that amount on his return) after deducting from the amount on the sale reports $247,587 for sales tax reimbursement and an additional, unexplained, $52,413. However, the Department found that the amounts of taxable sales recorded on the AM/PM sales reports were net of sales tax reimbursement. Our review of the report confirms that the sales tax reimbursement was itemized separately from the amounts itemized for nontaxable food sales, nontaxable lottery sales, taxable sales, and total sales. Accordingly, petitioner's reduction for sales tax reimbursement was not warranted (nor has the additional reduction of $52,413 been explained). We find that the available evidence controverts petitioner's assertion that the gross receipts reported on federal returns included sales tax reimbursement. That the $300,000 difference between recorded and reported taxable sales for the second quarter 2005 is close to the audited understatement of $321,752 is secondary support for the audit findings. We find that no adjustment is warranted.

Issue 2: Whether petitioner was negligent. We conclude that he was.

The Department imposed the negligence penalty because petitioner did not provide adequate records for sales and use tax purposes and because of the substantial understatement. Petitioner disputes the penalty on the basis that the understatement was the result of clerical errors and because this was his first audit.

Although petitioner claimed to have prepared his sales and use tax returns based on the amounts recorded in the AM/PM sales reports, he provided those reports only for one station for a portion of the audit period. Accordingly, the records provided were not sufficient to verify the accuracy of the sales and use tax returns. In addition, for the second quarter 2005, the only period for which petitioner provided an AM/PM sales report and a sales and use tax worksheet, petitioner's reported taxable sales were $300,000 less than the amount recorded in his own records. In addition, the understatement of reported taxable sales of $5,173,775 is substantial, and it represents an error ratio of about 14 percent. Even with no prior audit history, inadequate records coupled with an error ratio of 14 percent and an understatement exceeding $5 million, as well as a difference of $300,000 between recorded and reported sales for the second quarter 2005 show petitioner's negligence. We find that the penalty was properly applied.

OTHER DEVELOPMENTS

None.

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