# CALIFORNIA STATE BOARD OF EQUALIZATION

## APPEALS DIVISION BOARD HEARING SUMMARY

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| In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of: | |
| IMAD ELIAS MAHLI & ELIAS NIMAN MAHLI, dba A to Z Smoke Shop | Account Number SR EH 100-913281<br>Case ID 531323 |
| Petitioner | San Dimas, Los Angeles County |

Type of Business: Smoke shop

Audit period: 05/01/07 – 07/31/08

| Item | Disputed Amount |
|---|---|
| Unreported taxable sales | $432,246[1] |
| Negligence penalty | $ 3,445 |

| | Tax | Penalty |
|---|---|---|
| As determined and proposed to be redetermined | $34,453.88 | $3,445.40 |
| Less concurred | - 954.80 | 00.00 |
| Balance, protested | $33,499.08 | $3,445.40 |
| Proposed tax redetermination | $34,453.88 | |
| Interest through 07/31/12 | 11,790.22 | |
| Negligence penalty | 3,445.40 | |
| Total tax, interest, and penalty | $49,689.50 | |
| Monthly interest beginning 08/01/12 | $ 172.27 | |

### UNRESOLVED ISSUES

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

Petitioner operated a smoke shop from May 1, 2007, through July 31, 2008, when it sold the business. Petitioner provided no books and records for audit. The Sales and Use Tax Department (Department) established audited sales on a markup basis. Since the business had closed when the audit began and petitioner provided no information regarding its selling prices and costs, the

[1] Petitioner argues that this audit item is overstated but has not computed the amount with which it concurs. Accordingly, we show the entire amount of this audit item as disputed.

Department used cost and selling price information from the successor's business to compute audited markups for tobacco products, cigarettes sold by the pack, and cigarettes sold by the carton. Using the ratios of purchases in the various product categories, the Department computed a weighted average markup of 12.22 percent. To establish audited purchases, the Department used information provided by Sam's Club, a primary vendor, and purchase invoices for the period May 2007 through May 2008, which had been left at the business location and were provided by the successor. The Department reduced audited purchases by the estimated cost of self-consumed merchandise of $8,321, based on petitioner's representation that it consumed 17 cartons of cigarettes per month, and by estimated pilferage losses, computed at 1 percent. To establish the audited cost of goods sold, the Department then deducted $25,000 for ending inventory, as recorded in the contract for sale of the business. The Department added the audited markup to the audited cost of goods sold and computed audited taxable sales of $512,329, which exceeded reported amounts of $80,082, by $432,247.

Petitioner contends that the audited amount of taxable sales is excessive because the audited cost of goods sold and the audited markup are each too high. Specifically, petitioner claims that the purchases from Sam's Club include purchases made, unknown to petitioner at the time, by a trusted friend, using his own funds. Petitioner also asserts that the 2008 purchases for Summit Wholesale, which the Department computed using the average purchases from that vendor in 2007, are overstated because petitioner began using Sam's Club as its main supplier. In addition, petitioner states that audited purchases for July 2008 should be reduced because the business was winding down. Further, petitioner asserts that the cost of the ending inventory was actually $45,000, even though the cost was shown in the contract was $25,000, because the buyer would not agree to show the full amount. Regarding the markup, petitioner contends that it is not appropriate to use information from the successor to establish the audited markup, arguing that its operations were not similar to the successor's. Also, petitioner disputes the Department's decision to exclude the cartons from the shelf test which reflected negative markups. Petitioner has computed a markup for tobacco and cigarettes combined of 6.98 percent

Petitioner has not provided records to support its reported sales, and we find the Department was justified in using the markup audit approach. Petitioner has not provided any documentation, such as purchase invoices, to document the alleged unauthorized purchases from Sam's Club or to more accurately establish the purchases from Summit in 2008. Similarly, petitioner has offered no documentation, such as a physical inventory count, to show that the amount of ending inventory was greater than the amount stated in the contract of sale. Also, petitioner has provided no documentation to show that its operations were not similar to the successors or records from which its selling prices and costs could be determined, such that a shelf test could be conducted. In the absence of evidence, we find no adjustments are warranted.

**Issue 2:** Whether petitioner was negligent. We conclude that it was.

The Department imposed the negligence penalty because petitioner did not provide records and the understatement was substantial. Petitioner disputes the penalty, acknowledging that formal records were not maintained but stating that it did its best to operate the business. Petitioner also notes this was the first audit of this business. Finally, petitioner asserts that the negligence penalty does not serve as an incentive to correct deficiencies in the future because the business has closed.

Petitioner did not provide any source documents, such as cash register tapes, or any sales tax worksheets or other summary schedules supporting the amounts reported on sales and use tax returns. In addition, the understatement of $432,246 and error ratio of 539 percent are both substantial. We find that the lack of records and the large understatement are strong evidence that petitioner did not exercise due care in recordkeeping or reporting. Further, we find that any businessperson, even one with limited experience, should have recognized that his or her recorded costs far exceeded the reported sales. Petitioner acknowledges having made purchases of $106,883 from Summit during the period May 1, 2007, through December 31, 2007, and these undisputed purchases alone exceed reported sales of $36,000 by $70,783. In sum, even though petitioner was not audited previously, we find that there is clear evidence of negligence, and that the penalty was properly applied.

## OTHER MATTERS

None.

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

## MARKUP TABLE

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| Percentage of taxable vs. nontaxable purchases | 100% |
| Mark-up percentages developed | 12.22% |
| Self-consumption allowed in dollars | $8,321 for the audit period |
| Self-consumption allowed as a percent of taxable purchases | 1.68% |
| Pilferage allowed in dollars | $4,864 for the audit period |
| Pilferage allowed as a percent of taxable purchases | 1% |