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:	
MAISA, INC., dba El Toro Market 6	Account Number: SR EH 100-391505 Case ID 485794
Petitioner	Vista, San Diego County

Type of Business: Grocery store

Audit period: 07/01/04 – 03/31/08

Item	Disputed Amount
Unreported taxable sales	$491,417
Negligence penalty	$ 11,727

	Tax	Penalty
As determined and proposed to be redetermined:	$117,272.14	$11,727.21
Less concurred	- 79,187.30	00.00
Balance, protested	$ 38,084.84	$11,727.21

Proposed tax redetermination	$117,272.14
Interest through 8/31/11	50,624.89
Negligence penalty	11,727.21
Total tax, interest, and penalty	$179,624.24
Monthly interest beginning 9/1/11	$ 586.36

This matter was scheduled for Board hearing on May 24, 2011, but was postponed at petitioner's request because one of the principals involved was out of the country.

UNRESOLVED ISSUES

Issue 1: Whether adjustments are warranted to the audited understatement of reported taxable sales. We recommend no adjustment.

Petitioner operated a grocery store with a liquor department until June 30, 2008, when its seller's permit was closed because the business was transferred, for no consideration, to another corporation set up by the same family, Reem-J Inc. (SR EH 101-097390). Petitioner's reported sales amounts were based on its sales journal, which reconciled with its profit and loss statements. The Sales and Use Tax Department (Department) found that the audited cost of taxable goods sold (which included unrecorded purchases identified by vendors) exceeded reported taxable sales for the entire audit period. On the basis of this analysis, the Department concluded that reported taxable sales were substantially understated, and it decided to establish audited taxable sales on a markup basis.

To establish audited purchases of taxable merchandise, the Department contacted petitioner's known vendors. Since the information provided by vendors was most complete for 2006, the Department used 2006 as a test period. After the audit was completed, petitioner provided a purchase summary, prepared by its bookkeeper, summarizing recorded merchandise purchases from the same vendors the Department had contacted. However, petitioner did not provide any source documents to support that summary. Although petitioner scheduled total merchandise purchases of $766,846 for 2006 from those vendors, it arbitrarily adjusted that figure down to $734,684, which was the amount of *taxable* purchases the Department had computed based on the vendor information for 2006.[1] In the revised audit, the Department rejected that arbitrary adjustment and used the total merchandise purchases of $766,846 from the vendors at issue, which were scheduled by petitioner. The Department also revised the audited percentages of taxable to total purchases from some of the vendors based on additional information provided by petitioner, and it computed taxable purchases of $728,955 (a reduction of $5,729 from the amount computed in the audit). The Department compared that figure to the amount of taxable purchases recorded in the profit and loss statements to compute an understatement in recorded taxable purchase of 69.13 percent, which it applied to purchases of taxable merchandise recorded on the profit and loss statements for the remainder of the audit period.

To establish the audited cost of taxable merchandise sold, the Department reduced audited purchases of taxable merchandise by one percent for self-consumed merchandise and one percent for pilferage. The Department conducted shelf tests, using costs from purchase invoices and posted selling prices or prices provided orally by the store manager, to compute a weighted average markup for

[1] In the audit, the Department had scheduled total purchases from the vendors it contacted of $760,867 ($5,979 less than the amount scheduled by petitioner). Since some of those vendors also sold exempt food products, the Department computed the percentages of taxable to total merchandise purchases for each vendor. Upon application of those percentages, the Department computed that petitioner had purchased taxable merchandise totaling $734,684 from the vendors at issue.

taxable sales of 21.40 percent, which it applied to audited cost of taxable merchandise sold to establish audited taxable sales, which exceeded reported taxable sales by $1,469,432.

Petitioner contends that the audited understatement of reported taxable sales is excessive because: 1) the audited purchases of taxable merchandise are excessive; 2) the purchase segregation test of 2006 is inaccurate and not representative of the entire audit period; 3) the audited markup is excessive because the selling prices used in the shelf tests for beer and tobacco products are incorrect; and 4) an allowance should be made for losses related to bad debts on taxable sales. Petitioner provided schedules on which it computes an understatement of $978,015, which is $491,417 less than computed by the Department.

With respect to the assertion that purchases of taxable merchandise are excessive, petitioner contended at the conference that purchases of taxable merchandise should be based on information provided by vendors for 2006, rather than petitioner's purchase summary. In an email after the conference, petitioner contended that, instead of using 2006 as a test period, the audited taxable purchases should be based on the information provided by vendors for the entire period it was requested by the Department (July 1, 2004, through June 30, 2007). Although petitioner agreed to provide information and documentation after the conference to support these assertions, it submitted nothing, even though we allowed over three months for it to do so. Since some of the vendors did not provide information for the all periods requested, using only information from vendors to establish purchases on an actual basis would clearly understate petitioner's purchases. The Department concluded the information provided by vendors was most complete for 2006. Although petitioner states that the purchase activity for 2006 was not representative of the entire audit period, it has provided no supporting evidence. We find it was reasonable to use 2006 as the test period. We also reject petitioner's assertion that, for 2006, audited taxable purchases should be based on the information provided by vendors, rather than petitioner's own schedule of purchases from those vendors. Petitioner is asserting that the purchase summary *it provided* is inaccurate, but it has neither provided supporting documentation nor explained the cause of the alleged inaccuracy in the schedule. We find it improbable that petitioner would have listed purchases on the summary that it did not make, and we recommend no reduction of the audited purchases of taxable merchandise for 2006.

Petitioner has failed to provide evidence to support its claim that the segregation test conducted using purchase information for 2006 is not representative or to support its claim that incorrect selling prices were used in the shelf tests. Further, regarding the shelf tests, we find that the audited markup of approximately 21 percent is reasonable, and petitioner has provided no evidence to the contrary. Accordingly, we recommend no adjustment to the audited percentages of taxable to total purchases or to the audited markup. Regarding petitioner's assertion that it had losses related to unclaimed bad debts, we find that petitioner has not provided sufficient documentation to show that any sales were made on account or that it incurred any bad debts related to merchandise sales. Therefore, we recommend no adjustment for bad debts. For all these reasons, we recommend no adjustment to the audited cost of taxable merchandise sold.

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

The Department imposed the negligence penalty because it found that petitioner's records were inadequate and because the understatement was substantial. Petitioner does not believe it was negligent and disputes the penalty because this was its first audit and it relied on its outside bookkeeper to maintain records and properly report tax due.

Petitioner's records were inadequate and incomplete. The amounts of purchases recorded in the profit and loss statements were supported by fragmented source documents, and the Department has shown that recorded taxable purchases were understated by 69 percent. Further, total audited taxable sales were $3,388,034 and petitioner's total reported taxable sales were $1,918,602. This results in an understatement measured by $1,469,432, an error rate of 77 percent, both of which are substantial. We find that the inadequate records and significant understatement are evidence that petitioner did not exercise due care in record-keeping or reporting. Petitioner's argument that it relied on its bookkeeper to properly report tax is unavailing because petitioner was responsible for reporting its sales accurately, and it should have reviewed the returns to verify that they were correct. Although we recognize this was petitioner's first audit, we would expect any business person, even one with limited experience, to recognize the degree of error which is applicable here. For all these reasons, we find petitioner was negligent, and the penalty was properly imposed.

OTHER DEVELOPMENTS

None.

Summary prepared by Thea Etheridge, Business Taxes Specialist II

MARKUP TABLE

Percentage of taxable vs. nontaxable purchases	64%
Mark-up percentage developed	21.40%
Self-consumption allowed in dollars	$22,371 for 7/1/04 – 6/30/07
Self-consumption allowed as a percent of taxable purchases	1.01%
Pilferage allowed in dollars	$21,972
Pilferage allowed as a percent of total purchases	1%