

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:)
SHADY KATHEM MUHAMMAD) Account Number: SR EH 97-863378
dba Smart Buy) Case ID 404603
Petitioner)
Fontana, San Bernardino County

Type of Business: Smoke shop
Audit period: 10/01/03 – 09/18/06

<u>Item</u>	<u>Disputed Amount</u>		
Unreported sales	\$281,338		
Negligence penalty	\$2,571		
		<u>Tax</u>	<u>Penalty</u>
As determined and proposed to be redetermined:		\$25,713.86	\$2,571.38
Less concurred		- 3,910.12	<u>00.00</u>
Balance, protested		<u>\$21,803.74</u>	<u>\$2,571.38</u>
Proposed tax redetermination		\$25,713.86	
Interest through 3/31/11		13,771.49	
10% penalty for negligence		<u>2,571.38</u>	
Total tax, interest, and penalty		<u>\$42,056.73</u>	
Monthly interest beginning 4/1/11		<u>\$150.00</u>	

This matter was previously scheduled for Board hearing on October 20, 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 contacted the Board Proceedings Division to request an oral hearing before the Board.

UNRESOLVED ISSUES

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

Petitioner operated a smoke shop from June 25, 2001, through September 18, 2006, when the business was sold. The majority of petitioner’s sales were taxable sales of tobacco products and soda.

1 Petitioner's accountant prepared the sales and use tax returns using sales amounts provided orally by
2 petitioner. The Sales and Use Tax Department (Department) found that the amounts of sales recorded
3 on the financial statements reconciled with gross receipts reported on federal income tax returns and
4 total sales reported on sales and use tax returns. However, the amount of purchases shown on the
5 income tax returns for the years 2003, 2004, and 2005 exceeded the amounts recorded in the financial
6 statements for the same years by \$86,803. As a result of that discrepancy, the Department contacted
7 petitioner's vendors regarding the amounts of their sales to petitioner. To establish audited purchases
8 of taxable goods, the Department used the information provided by Sam's Club, the only vendor from
9 whom petitioner purchased taxable merchandise. To establish the audited cost of taxable goods sold,
10 the Department reduced the purchases for 2006 by \$18,000 (the sale of inventory to the new owner of
11 the business) and reduced audited purchases for the audit period by one percent for shrinkage. The
12 Department conducted shelf tests, using costs shown on purchase invoices and selling prices provided
13 by petitioner, to establish the audited markups of 3.89 percent for cigarettes¹ and 78.10 percent for
14 soda. The Department then computed a weighted average markup, using the percentages of taxable to
15 total merchandise purchases it computed from the shelf test of 99.56 percent cigarettes and
16 0.44 percent soda, respectively.² The Department used the audited cost of taxable goods sold and the
17 audited markup to computed audited taxable sales, which exceeded reported amounts by \$281,338.

18 Petitioner contends that the audited understatement of reported taxable sales is excessive
19 because the allowance for shrinkage should be increased. The petition, prepared by petitioner's former
20 representative, also includes an assertion that the allowance for self-consumption is not sufficient,
21 despite the fact the petitioner has, on several occasions, stated that he did not withdraw items from
22 inventory for consumption.

23 With respect to self-consumption, it does not appear that during the conference petitioner
24 actually argued for self-consumption and that the issue was addressed in the D&R based on the
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26 ¹ The markup for cigarettes is calculated using petitioner's estimate of 80 percent sales as cartons and 20 percent as packs.

27 ² Using the figures the Department had scheduled for the entire audit period, we compute 0.91 percent of purchases of
28 taxable merchandise represented soda. If that percentage were used, the weighted average audited markup would increase
because the audited markup for soda is significantly higher than the audited markup for cigarettes. The D&R does not
recommend an increase in the audited markup, and the Department has not asserted an increase on this basis.

1 argument the former representative included in the petition. In any event, upon further consideration,
2 we believe that this issue should have been specifically discussed with petitioner during the conference
3 to ensure he understood that any self-consumption he did have would reduce his tax liability (even if
4 not by much). The D&R instead concludes that no adjustment is warranted because petitioner's
5 statements during the audit conflict with the argument in the petition. Based on the record before us,
6 we cannot be certain that petitioner fully understood the issue. In any event, as noted in footnote 2, it
7 appears that the Department's calculation of the weighted markup was generous to petitioner by not
8 accounting for all purchases of soft drinks, which had a far higher markup than cigarettes. If the
9 calculations had been performed properly, the weighted markup would have been increased. If we
10 were to recommend an adjustment for self-consumption, we would also recommend that the error in
11 calculation of the weighted markup be corrected as well, which would fully offset any allowance for
12 self-consumption. Thus, while we find that this issue should have been addressed more fully at the
13 conference and in the D&R, our conclusion remains that no adjustment is warranted.

14 Regarding the contention that the allowance for shrinkage should be increased, petitioner has
15 provided no police reports or other documentation to demonstrate that the allowance for shrinkage
16 should be greater than the standard allowance of one percent. In the absence of evidence of such theft,
17 we recommend no increase in the allowance for shrinkage. Further, we have reviewed the audit
18 workpapers and have found no inherent errors or inaccuracies that would result in a reduction of the
19 audited understatement.

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

21 The Department imposed the 10-percent penalty for negligence because petitioner's records
22 were not adequate for sales and use tax purposes and, as a result, the Department was required to use
23 an alternate audit approach (the markup method) to establish audited taxable sales. Petitioner protests
24 the penalty on the basis that he hired an accountant to prepare sales and use tax returns and financial
25 statements. He also asserts that the reason some of his records were not available is that they were lost
26 when he moved across the street.

27 Petitioner provided no records to support his summary records of sales. Although he had hired
28 an accountant to prepare returns and financial statements, petitioner provided total sales amounts to the

1 accountant orally. With respect to recorded purchases, those figures were the amounts compiled from
2 purchase invoices provided by petitioner to the accountant, but the invoices provided were not
3 complete. Thus, both the recorded sales and purchases were substantially understated. With respect to
4 petitioner's assertion that some records were lost in the move, the evidence in the Department's files
5 indicates that petitioner moved before the audit period began. Thus, any records lost during that move
6 would be irrelevant for this audit. Further, we note that petitioner's purchases of taxable merchandise
7 of \$1,121,467 for the audit period substantially exceeded his reported taxable measure of \$857,013.
8 We find that any businessperson, even one with limited experience, should have noted a discrepancy of
9 that magnitude. Accordingly, we find petitioner did not exercise due care in recording or reporting, the
10 understatement was the result of negligence, and the penalty was properly applied.

11 **OTHER DEVELOPMENTS**

12 None.

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14 Summary prepared by Rey Obligacion, Retired Annuitant
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MARKUP TABLE

Percentage of taxable vs. nontaxable purchases	Unknown*
Mark-up percentages developed	3.89% for tobacco products 78.10% for soda 4.22% overall (weighted average)
Self-consumption allowed in dollars	None
Pilferage allowed in dollars	\$11,215 for the audit period
Pilferage allowed as a percent of total purchases	1%

* In its examination of purchases, the Department found that all taxable merchandise had been purchased from one vendor. Accordingly, instead of computing a percentage of taxable to total merchandise purchased, the Department compiled taxable purchases from that vendor.