

1 CALIFORNIA STATE BOARD OF EQUALIZATION

2 APPEALS DIVISION BOARD HEARING SUMMARY

3 In the Matter of the Petitions for Redetermination)
 4 Under the Sales and Use Tax Law of:)
 5 MOHAMAD MARWAN NAFEH,) Account Number: SR AP 97-825903
 dba Tobacco World) Case IDs 326425, 515731
 6)
 7 Petitioner) Arcadia, Los Angeles County

8 Type of Business: Tobacco retailer

9 Audit periods: 3/1/01 – 12/31/03 (Case ID 326425)
 10 7/1/05 – 3/31/08 (Case ID 515731)

11 Item	Disputed Amounts			
	326425	515731		
12 Unreported taxable sales	\$271,000	\$321,001		
13 Unreported taxable rebates	\$174,139	\$40,192		
14 Negligence penalty	\$7,160	\$2,980		
			326425	515731
			<u>Tax</u>	<u>Penalties</u>
15 As determined	\$71,600.68	\$12,837.13	\$31,180.31	\$3,118.05
16 Post D&R adjustment	0.00	0.00	- 206.84	- 20.70
17 Proposed redetermination	\$71,600.68	\$12,837.13	\$30,973.47	\$3,097.35
18 Concurring in	-35,120.48	0.00	0.00	0.00
Balance, protested	<u>\$36,480.20</u>	<u>\$12,837.13</u>	<u>\$30,973.47</u>	<u>\$3,097.35</u>
19 Proposed tax redetermination	\$71,600.68		\$30,973.47	
Interest through 10/31/12	59,300.52		14,694.82	
20 Negligence penalty	<u>7,160.05</u>		<u>3,097.35</u>	
Total tax, interest, and penalties	\$138,061.25		\$48,765.64	
21 Payments	- 1,503.00		0.00	
22 Balance Due	<u>\$136,558.25</u>		<u>\$48,765.64</u>	
23 Monthly interest beginning 11/1/12	<u>\$350.49</u>		<u>\$154.87</u>	

24 UNRESOLVED ISSUES

25 **Issue 1:** Whether further adjustments are warranted. We conclude no further adjustments are
 26 warranted.

27 Petitioner has operated a tobacco and cigarette store since March 2001. In both audits at issue
 28 here, the Sales and Use Tax Department (Department) was unable to reconcile petitioner's reported

1 sales to any recorded amounts, so it decided to establish taxable sales by the markup method. For the
2 earlier audit period (3/1/01 – 12/31/03), the Department regarded petitioner as having sold only
3 cigarettes, and on examination determined that petitioner sold 66.79 percent of his cigarettes by the
4 carton and 33.21 percent by the pack based on a test of petitioner's sales summaries for the third
5 quarter 2004. It used the Forms 1099 from Philip Morris Inc. that contain petitioner's cigarette rebate
6 and sales information to establish petitioner's cost of cigarettes sold. It applied an audited markup of
7 16.89 percent for pack sales and an audited markup of 3.38 percent for carton sales to compute audited
8 taxable sales of \$1,012,707, and compared this amount to reported taxable sales of \$313,221 to
9 compute unreported taxable cigarette sales of \$699,486. For the later audit period (7/1/05 – 3/31/08),
10 the Department compiled 2007 merchandise purchases from purchase invoices and a vendor survey,
11 compared that amount with the merchandise cost reported on the 2007 Federal income tax return,
12 calculated a merchandise cost understatement error rate of 120.29 percent, and applied that error rate to
13 one half of the merchandise cost reported on the 2005 Federal income tax return and the merchandise
14 cost reported on the 2006 Federal income tax return to compute taxable merchandise costs of \$648,417
15 for July 2005 through December 2007. It applied an audited markup of 17.54 percent (established in
16 part by using a cigarette sales ratio of 70 percent cartons to 30 percent packs based on examination of
17 petitioner's z-tapes for April 2006 through March 2008) to the audited taxable merchandise costs to
18 compute audited taxable sales of \$762,149 which, when compared to reported taxable sales of
19 \$452,541, resulted in unreported taxable sales of \$309,608 for July 2005 through December 2007.
20 Finally, it computed an understatement error rate of 60 percent for 2007 which it applied to reported
21 taxable sales for the first quarter 2008 to compute unreported taxable sales of \$28,141. Thus, the
22 Department computed that petitioner understated his taxable sales by \$337,750. At the appeals
23 conference, the Department recommended a two percent adjustment to the audited taxable merchandise
24 cost for spoilage, and that adjustment reduced unreported taxable sales to \$321,001. No adjustment
25 has been made for self consumption, and at the conference petitioner confirmed that there was no self
26 consumption or promotional giveaways.

27 For the earlier audit period, petitioner does not dispute the Department's method of establishing
28 audited total sales, but contends that at least \$271,000 of the unreported sales represent nontaxable

1 sales for resale. For the later audit period, petitioner contends the audited merchandise costs are
2 overstated, the Department should have established audited taxable sales by an observation test, and
3 the cigarette sales should be weighted 50 percent cartons to 25 percent packs (he was not clear as to
4 how the remaining 25 percent would be allocated).

5 Petitioner has not provided documentation such as resale certificates or responses to XYZ
6 letters from his alleged resale customers to support that any of the unreported sales from the earlier
7 audit period represent valid sales for resale. Some of those customers have specifically denied making
8 cigarette purchases from petitioner. We question the credibility of the sales invoices provided in
9 support of the sales for resale transactions since duplicated invoice numbers have been used for
10 different alleged sales, and the customer information listed on them is insufficient to properly identify
11 each customer's status as a permitized retailer. With respect to the later audit period, we find that the
12 2007 merchandise costs were obtained directly from petitioner's vendors and are therefore reliable for
13 use in the markup analysis. Petitioner has not demonstrated how the use of an observation test would
14 result in a more accurate calculation of audited taxable sales. We note that using the Department's
15 70/30 cigarette carton-to-pack sales ratio is more beneficial to petitioner in the calculation of audited
16 taxable sales than his alleged 50/25/25 sales ratio. Accordingly, we conclude no further adjustment to
17 the audited understatement of taxable sales is warranted.

18 **Issue 2:** Whether petitioner has established that adjustments are warranted to the unreported
19 taxable cigarette rebates from manufacturers. We conclude that he has not.

20 During the audits, the Department determined that petitioner received cigarette rebates from
21 cigarette manufacturers in exchange for a reduction in the retail selling price of the cigarettes.
22 Accordingly, the Department included those rebates in petitioner's taxable gross receipts from his
23 retail sales of cigarettes (\$174,139 for the earlier audit period and \$40,192 for the later audit period).
24 Petitioner does not dispute that the cigarette rebates are part of taxable gross receipts, but contends that
25 they were included in the markup calculation and should not be assessed as an additional taxable
26 measure. However, the rebates were not part of the markup calculation. Rather, in its shelf tests, the
27 Department used the lower discounted sales prices when the rebates were in effect, meaning that the
28 Department's analyses excluded the manufacturer cigarette rebates from the markup calculation.

1 Therefore, we find that there was no duplication of the measure of tax, and recommend no adjustments
2 to the unreported taxable cigarette rebates.

3 **Issue 3:** Whether petitioner was negligent. We conclude that he was.

4 The Department imposed negligence penalties because petitioner's books and records were
5 grossly inadequate and incomplete. For both audits petitioner did not maintain or provide for audit
6 purchase or sales journals, or sales tax worksheets. The Department also found that the \$873,625 and
7 \$361,193 audited understatements of taxable sales, representing error rates of 278.91 percent for the
8 earlier audit period and 72.32 percent for later audit period, were quite significant. Petitioner contends
9 that for the earlier audit period, he was new to the business, and that he relied on his accountant to
10 properly report his tax liability. For the later audit period, petitioner generally contends that he was not
11 negligent.

12 Petitioner failed to provide books, records, or purchase and sales information to support his
13 reported sales, and even after the earlier audit, failed to correct the deficiencies in his recordkeeping.
14 We conclude that petitioner was negligent in recordkeeping. We further find that the large
15 understatements and high error rates are evidence of negligence in reporting during both audit periods.
16 We conclude that petitioner was negligent and that the negligence penalties were properly imposed.

17 OTHER MATTERS

18 Since petitioner did not participate in the amnesty program, the determination for the earlier
19 audit period includes an amnesty double negligence penalty of \$5,677.08 for the portion of the
20 negligence penalty incurred for the amnesty-eligible periods (prior to January 1, 2003), and an amnesty
21 interest penalty of \$6,403.67 will be imposed when the liability is final. Petitioner submitted a request
22 for relief of the amnesty penalties, signed under penalty of perjury, in which he admitted having
23 received notice of the amnesty program from the Board, but asserted that he did not participate because
24 he relied on his accountant's advice that he did not need it. The D&R notes that petitioner could not
25 just blindly follow his accountant's advice, and states that, when the amnesty period was open,
26 petitioner had already been put on notice that he had underreported his tax liability for amnesty-
27 eligible periods because the Department had contacted petitioner about the audit more than a year
28 earlier. The D&R states further that the Department was well into the audit by the amnesty period and

1 could have provided petitioner with preliminary audit schedules by the amnesty deadline. Based on
2 this, the D&R concludes that the amnesty penalties should not be relieved due to petitioner's alleged
3 reasonable cause.

4 The D&R then discusses the Board's March 18, 2008 order that, for cases such as this one, the
5 amnesty interest penalty applicable to the tax measured by the cigarette rebates should be relieved if,
6 within 30 days of the date of the notice of the final decision in the appeal, "the taxpayer either pays the
7 remaining amount of amnesty-eligible tax and interest due or enters into a qualifying installment
8 payment agreement for full payment of the remaining amount of amnesty-eligible tax and interest due
9 within 13 months, and successfully completes that payment agreement." The quoted portion does not
10 accurately state the Board's order since it is not limited to the penalty related to the tax on the rebates,
11 and apparently led to an incorrect recommendation in the D&R that the amnesty interest penalty be
12 relieved (in full) if the payment condition is satisfied. Since this recommendation was based on the
13 Board's March 18, 2008 order and not based on a specific finding of reasonable cause, it should not
14 have exceeded the scope of the Board's order, which applies to the amnesty interest penalty imposed
15 with respect to the amnesty-eligible tax due *on cigarette rebates*, and not to all amnesty interest
16 penalties incurred when any portion of the liability relates to cigarette rebates (here, only about 20
17 percent of the liability was from cigarette rebates, and thus relief under the Board's order is limited to
18 the same percentage of about 20 percent). In sum, the D&R recommends relief of the entire amnesty
19 interest penalty, subject to the payment condition, but recommends that relief of the amnesty double
20 amnesty penalty be denied (the Board's order was limited to the amnesty interest penalty).

21 Upon review of the D&R, we conclude that it made findings of fact based on inadequately
22 stated evidence. The D&R effectively accepted petitioner's assertion that he relied on advice from the
23 accountant. Since we have no facts to the contrary, we accept that implicit finding. The D&R goes on
24 to find, however, that petitioner was not entitled to just blindly follow that advice, and we agree. If
25 petitioner had clear information that the Department's position was that additional tax was due, then
26 we would agree that petitioner would not have been entitled to ignore the amnesty information the
27 Department had provided to him just because the accountant told petitioner he could do so. The
28 analysis all depends on what petitioner knew, and when he knew it. That is, did petitioner know, by

1 the end of the amnesty period, that he had or was likely to have a tax liability? On this point, the one
2 thing that is clear is that the finding of knowledge by the D&R is faulty. That finding was stated as
3 having been based on the fact that an audit was to be conducted and that, since the audit was well
4 under way before the end of the amnesty period, the Department could have provided petitioner
5 preliminary schedules. However, these points do not go to the issue of whether petitioner had reason
6 to believe additional tax was due.

7 In deciding how to resolve the deficiencies in the D&R's analysis, we consider these factors:
8 the D&R considered that this issue presented a "close case"; the D&R's finding that petitioner had
9 been put on notice of his underreporting for the amnesty-eligible periods is not supported by facts
10 stated in the D&R; the D&R recommends conditional relief of all the amnesty interest penalty even
11 though the stated basis for that relief applies to only about 20 percent of the penalty¹; and any relief
12 will, of course, be conditioned on petitioner's actual payment in accordance with the usual payment
13 conditions, meaning that such relief will be applicable only if it successfully serves the goal of
14 obtaining payment of the tax due, consistent with the amnesty program's goals. Under the specific
15 circumstances of this case, we conclude it is appropriate to find that petitioner has shown reasonable
16 cause to relieve the amnesty penalties. We therefore overrule our prior recommendation and
17 recommend instead that all amnesty penalties be relieved if, within 30 days of the issuance of the
18 Notice of Redetermination in this matter, petitioner either pays all amnesty eligible tax and interest due
19 or enters into an installment payment plan to pay such amounts within 13 months and successfully
20 completes that agreement; if petitioner does not satisfy this payment condition, the amnesty penalties
21 would remain applicable.

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23 Summary prepared by David H. Levine, Tax Counsel IV
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27 ¹ The relevance of this factor is that, if there is not a basis for relieving the amnesty penalties other than the Board's March
28 18, 2008 order, we would have to remove this matter from the Board's October calendar to issue a SD&R to correct the
mistake and limit the relief to that ordered by the Board.

MARKUP TABLE

	326425	515731
Percentage of taxable vs. nontaxable purchases	100% taxable, all consisting of cigarettes	99.66% taxable, consisting of 93.60% cigarettes 3.32% cigars 3.00% misc. taxable 0.08% sodas
Cigarette sales ratios	66.79% cartons 33.21% packs	70.32% cartons 29.68% packs
Mark-up percentages developed	16.9% cigarettes (packs) 3.4% cigarettes (cartons)	12.44% cigarettes (packs and cartons) 73.11% cigars 113.16% miscellaneous
Self-consumption allowed in dollars	\$0	\$0
Self-consumption allowed as a percent of taxable purchases	0%	0%
Pilferage allowed in dollars	\$0	\$12,968 spoilage
Pilferage allowed as a percent of taxable purchases	0%	2% spoilage