CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION SUMMARY FOR BOARD HEARING

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of: NELLY'S MARKET, INC. dba Texas Food and Spirits Petitioner	Account Number: SR FH 25-728939 Case ID 445459 San Diego, San Diego County

Type of Business: Two liquor stores

Audit period: 01/01/04 – 12/31/06

Item	Disputed Amount
Unreported taxable sales	$274,355

	Tax	Penalty
As determined:	$24,991.22	$2,499.13
Adjustment - Appeals Division	- 3,458.03	-2,499.13
Proposed redetermination	$21,533.19	$ 00.00
Less concurred	- 270.63	
Balance, protested	$21,262.56	
Proposed tax redetermination	$21,533.19	
Interest through 6/30/10	9,718.73	
Total tax and interest	$31,251.92	
Payments	- 555.00	
Balance Due	$30,696.92	
Monthly interest beginning 7/1/10	$ 122.37	

UNRESOLVED ISSUE

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

Petitioner has operated two liquor stores since December 1, 1980. The Sales and Use Tax Department (Department) used reported taxable sales and recorded purchases of taxable merchandise to compute book markups of 23.75 percent, and 28.7 percent, respectively, for the period April 1, 2004, through December 31, 2005, and the year 2006. The Department considered those markups lower than expected for this business and decided to establish audited taxable sales on a markup basis. The Department adjusted recorded purchases for inventory for the years 2004 and 2005, the years for which income tax returns were available. It then it applied percentages of taxable to total purchases, computed for each quarter, to establish the audited cost of taxable goods available for sale. To establish the audited cost of taxable goods sold, the Department reduced those figures by an estimated cost of self-consumed taxable merchandise of $291 per quarter, based on information provided by petitioner, and by a one percent pilferage allowance. The Department then conducted shelf tests to compute markups of approximately 50 percent for liquor, 39 percent for beer and wine, 45 percent for soda, 19 percent for tobacco products, 23 percent for periodicals, and 64 percent for miscellaneous taxable merchandise. Using the ratios of purchases in each merchandise category computed for November 2006, the Department computed a weighted average markup of 38.12 percent. It then applied that markup percentage to the audited cost of taxable goods sold to compute audited taxable sales.

Petitioner contends that the audited markups are excessive, arguing that the markup for wine and beer should be 30 to 32 percent, rather than 39 percent, and the markup for liquor should be about 40 percent, rather than 50 percent. Petitioner also argues that the markups computed at the time of the shelf test are not representative of the entire audit period because its markups increased during the audit period. In addition, petitioner contends that its purchases of tobacco products (the category for which the lowest markup was computed) represent a greater percentage of its total purchases than computed in the Department's purchase segregation. Petitioner asserts that the weighted average markups should be reduced to about 25 percent for 2004 and 2005 and 30 percent in 2006, but it has provided no documentation to support that assertion.

The audited markup of 38.12 percent is in the high end of the range of markups we expect in this type of business, 25 to 40 percent. In two prior audits of petitioner, the Department calculated a markup percentage for each year (or partial year), and these markup percentages fluctuated. The 38.12 percent markup computed in this audit falls within the high end of the range of markups the Department found in the prior audits. Based on these considerations, in the D&R we found that a 38.12 percent markup might not be representative of petitioner's operations for the entire audit period. To give effect to that concern, we recommended a reduction of two percent. However, to address petitioner's concern that the audited percentage of purchases of tobacco products should be increased, we also recommended that the Department first expand the purchase segregation and compute a revised weighted average markup, if petitioner provided the necessary records. In the post-conference reaudit, the Department did expand the purchase segregation test to include the three months of September, October, and November 2006, and it computed a slightly higher weighted average markup of 38.23 percent. In accordance with our recommendation, the Department then reduced that markup by two percent to 36.23 percent, which it used in the reaudit computations of audited taxable sales. We find that there is insufficient evidence to support further adjustments.

RESOLVED ISSUE

We find that petitioner was not negligent, and the negligence penalty should be deleted. After the adjustments in the reaudit dated August 28, 2009, the percentage of error in reported taxable measure is 9.4 percent ($277,847 ÷ $2,941,700). This percentage of error is somewhat large, but not exorbitant. Petitioner provided records that were adequate for sales and use tax purposes. In addition, petitioner reported its taxable sales by applying a markup to the recorded cost of taxable merchandise in order to avoid problems in reporting based on cash register receipts, such as when employees ring taxable sales as nontaxable. We accepted this as petitioner's attempt to report correctly, and noted in the D&R that its reporting error was the result of its having used a markup in its computations that was lower than the actual overall markup for the business. Further, petitioner has been audited twice before, with a small understatement established in the first audit, and no change to reported figures found in the second audit. Thus, this is not a situation wherein the errors are similar to errors identified in a prior audit. For all these reasons, we find that the understatement was not the result of negligence.

OTHER DEVELOPMENTS

None.

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

MARKUP TABLE

Percentage of taxable vs. nontaxable purchases	65.17% - 71.36%* Weighted average percentage- 67.6%
Mark-up percentages developed	36.23%
Self-consumption allowed in dollars	$1,164 per year
Self-consumption allowed as a percent of total purchases of taxable merchandise	0.15%
Pilferage allowed in dollars	$23,845
Pilferage allowed as a percent of total purchases	1%

* The Department computed a percentage of taxable to total merchandise purchases for each quarter.