

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:)
PYPK PRODUCTION, INC., dba) Account Number: SR AA 100-316282
El Rancho Market) Case ID 441163
Petitioner) Bell Gardens, Los Angeles County

Type of Business: Grocery store
Audit period: 07/01/04 – 06/30/07

<u>Item</u>	<u>Disputed Amount</u>		
Unreported taxable sales	\$624,538		
Negligence penalty	\$ 5,198		
		<u>Tax</u>	<u>Penalty</u>
As determined:		\$52,599.03	\$5,259.92
Adjustment - Appeals Division		- 624.61	- 62.42
Proposed redetermination		<u>\$51,974.42</u>	<u>\$5,197.50</u>
Less concurred		- 449.96	00.00
Balance, protested		<u>\$51,524.46</u>	<u>\$5,197.50</u>
Proposed tax redetermination		\$51,974.42	
Interest through 3/31/11		23,199.60	
Negligence penalty		<u>5,197.50</u>	
Total tax, interest, and penalty		<u>\$80,371.52</u>	
Monthly interest beginning 4/1/11		<u>\$ 303.18</u>	

UNRESOLVED ISSUES

Issue 1: Whether adjustments are warranted to the unreported taxable sales. We recommend no further adjustment.

Petitioner operates a grocery store making nontaxable sales of food and taxable sales of products such as beer, soda, tobacco products, and sundries. Petitioner also sells hot prepared food and provides seating facilities. The amounts reported on sales and use tax returns were based on figures petitioner had manually recorded in a notebook.

In its preliminary examination, the Sales and Use Tax Department (Department) found that the total sales reported for sales and use tax purposes substantially reconciled with the gross receipts

1 reported on income tax returns. Using the gross receipts and cost of goods sold reported on income tax
2 returns, the Department computed book markups of 88 percent for fiscal year ending (FYE)
3 September 30, 2005, and 100 percent for FYE 2006, which were substantially higher than the markups
4 the Department would expect for this type of business (25 to 35 percent). The Department regarded
5 the unusually high book markups as an indication that the reported cost of goods sold figures were
6 understated. Therefore, the Department reviewed purchase invoices and information provided by
7 petitioner's suppliers to establish an audited amount of purchases for the second quarter 2007 (2Q07),
8 which it used to estimate annual purchases. Using estimated annual purchases and petitioner's total
9 reported sales, the Department computed markups of 19 for FYE 2005 and 12 percent for FYE 2006,
10 and computed negative markups for taxable sales for both years. Since those overall markups were
11 substantially lower than expected and the calculations resulted in negative markups for taxable sales,
12 the Department concluded that reported taxable sales were understated.

13 The Department decided to establish taxable sales on a markup basis with a test period of 1Q06
14 through 2Q07, compiling purchase information from the available purchase invoices and from
15 information from petitioner's suppliers. The Department reduced purchases of taxable good by
16 1 percent for self-consumption and 1 percent for pilferage to establish audited cost of taxable goods
17 sold. The Department used costs from purchase invoices and selling prices posted on the shelf to
18 compute average markups for sales of taxable goods from each supplier, and used the percentage of
19 total purchases from each supplier to compute a weighted average markup of 29.92 percent. The
20 Department used the audited cost of taxable goods sold and the audited markup to compute audited
21 taxable sales other than hot prepared food. To determine the audited sales of hot prepared food, the
22 Department used receipts provided by petitioner for one week to compute average daily sales and used
23 the average daily sales to compute hot prepared food sales for the test period. The Department added
24 audited sales of hot prepared food to the other audited taxable sales to compute audited taxable sales
25 for the test period. The Department computed that audited taxable sales represented 58.53 percent of
26 reported total sales. It applied that percentage to reported total sales to establish audited taxable sales

1 for the audit period, which exceeded reported amounts by \$632,109.¹ Petitioner contended that the
2 audited cost of taxable goods sold was overstated because of errors in the purchase segregation and
3 argued that the pilferage loss should be increased to three percent. In the D&R, we recommended a
4 correction of one documented error in the purchase segregation and recommended an increase of the
5 pilferage loss to two percent. The effect of those adjustments was a reduction of the understatement of
6 \$7,571, to \$624,538.

7 Petitioner contends that the audited amount of taxable sales other than hot prepared food is
8 overstated because of errors in the purchase segregation test, and because the allowance for pilferage
9 should be increased from two percent to three percent. With respect to the segregation test, petitioner
10 asserts that it made more purchases of nontaxable goods than were reflected in the test. Petitioner also
11 argues that one purchase of taxable goods listed by a supplier should be deleted from the segregation
12 test because the amount is larger than other purchases from that supplier and therefore appears
13 erroneous. Further, petitioner contends that there were other unspecified errors in the purchase
14 segregation test, and that audited taxable sales of hot prepared food products are overstated because it
15 did not sell hot prepared food before October 2006.

16 Petitioner has not provided evidence such as police reports or insurance claims to support a
17 greater pilferage allowance than the 2 percent agreed to by the Department (based on the location of
18 the business in an area with higher-than-usual losses due to theft) and recommended in the D&R. We
19 thus recommend no further adjustment for pilferage. Petitioner has not provided documentation of any
20 additional purchases of nontaxable goods to support its disputes with the purchase segregation test, nor
21 has it provided an invoice or other evidence to support a lower amount with respect to the one purchase
22 of taxable goods it disputes as too high. We find that the size of the listed purchase, by itself, is not
23 evidence that the supplier's records were incorrect, and in the absence of documentation or even
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26 ¹ This approach is somewhat different from the markup audit method frequently used by the Department. The more
27 "typical" method is a comparison of audited and reported taxable sales to compute a percentage of error for the test period,
28 which is applied to reported taxable sales for the audit period. The Department did not use that procedure in this case
because petitioner's taxable sales had decreased steadily throughout the audit period. Therefore, the Department concluded
that the percentage of error in the test period might have been greater than the actual error rate in the earlier portions of the
audit period. If the Department had applied the percentage of error in reported taxable sales for the test period to reported
taxable sales, the understatement would have been over \$900,000 (substantially higher than the audited amount).

1 specific descriptions of the alleged errors, we find no further adjustments are warranted to audited
2 taxable sales other than hot prepared food.

3 Petitioner did not maintain records of its sales of hot prepared food, and in the absence of
4 records, the Department asked petitioner to retain receipts for a week, which it used to compute a daily
5 average amount of sales of hot prepared food. We find that audit procedure reasonable and appropriate
6 under the circumstances. The only evidence petitioner has provided to support its assertion that it did
7 not sell hot prepared food before October 2006, is a depreciation schedule showing a purchase of
8 equipment around that time. Petitioner states that the equipment purchased was cooking equipment,
9 and that it did not have facilities to prepare hot food prior to October 2006. We find that evidence
10 unpersuasive. First, there is no evidence to show that the equipment purchased in October 2006 was
11 cooking equipment. Even if that were verified, however, petitioner's statement is contradicted by
12 information from the Los Angeles County Department of Public Health stating that petitioner began
13 selling hot prepared food in May 2004. Accordingly, we find that there is no basis for adjustment of
14 the audited taxable sales of hot prepared food.

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

16 The Department imposed the negligence penalty because petitioner failed to maintain adequate
17 records for sales and use tax purposes, and petitioner's recorded purchases were understated by
18 approximately 70 percent. Petitioner notes that this was its first audit and disputes the negligence
19 penalty, asserting that any understatement resulted from its inexperience and lack of knowledge rather
20 than negligence.

21 Petitioner provided limited summary records and almost no source documents, and understated
22 its recorded purchases by about 70 percent. Petitioner's failure to record such a significant portion of
23 its purchases is strong evidence of a lack of due care in recordkeeping. When the Department used
24 petitioner's actual purchases to compute the audited cost of taxable goods sold, it found that the costs
25 substantially exceeded reported taxable sales for FYE 2005 and 2006, and it computed negative book
26 markups of 30 percent and 45 percent, respectively. Those broad discrepancies are strong evidence of
27 a lack of due care in reporting. Moreover, the audited understatement of reported taxable sales of
28 \$624,538 represents an error rate of 367 percent in comparison to reported taxable sales of \$170,347.

1 Petitioner has not provided a non-negligent reason for its failure to report that amount of taxable sales,
2 which is substantial, both as an absolute value and in relation to reported amounts. We conclude that
3 petitioner was negligent and the penalty properly imposed.

4 **OTHER DEVELOPMENTS**

5 None.

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7 Summary prepared by Deborah A. Cumins, Business Taxes Specialist III
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3 **MARKUP TABLE**
4 **Test Period January 1, 2006, through June 30, 2007**

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Percentage of taxable vs. nontaxable purchases	Unknown*
Mark-up percentages developed	29.92%
Self-consumption allowed in dollars	\$2,687 for the test period
Self-consumption allowed as a percent of total purchases	1%
Pilferage allowed in dollars	\$5,319 for the test period
Pilferage allowed as a percent of total purchases	2%

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13 * The Department segregated purchases for the 2Q07 and computed that 43 percent of petitioner's
14 purchases represented taxable goods. However, the Department subsequently determined that
15 recorded cost of goods sold were substantially understated. Accordingly, the Department used
16 information from vendors to establish audited taxable purchases for the test period. It did not
17 establish total purchases for the same period and did not compute a percentage of taxable to total
18 purchases.
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