STATE BOARD OF EQUALIZATION
SALES AND USE TAX APPEAL

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:	
MOKHIM RASOOLI & MALAK SAJADEH, dba J & C Food Store	Account Number: SR AC 97-553002 Case ID 432459
Petitioner	North Hollywood, Los Angeles County

Type of Business: Grocery store

Audit period: 10/01/03 – 09/30/06

Item	Disputed Amount
Unreported sales	$226,819
Negligence penalty	$ 1,871

	Tax	Penalty
As determined:	$23,358.31	$2,335.81
Adjustment - Sales and Use Tax Department	- 8,106.63	- 810.62
- Appeals Division	+ 3,460.96	+ 346.10
Proposed redetermination, protested	$18,712.64	$1,871.29

Proposed tax redetermination	$18,712.64
Interest through 6/30/10	8,594.42
10% penalty for negligence	1,871.29
Total tax, interest, and penalty	$29,178.35
Monthly interest beginning 7/1/10	$ 109.16

UNRESOLVED ISSUES

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

Petitioner has operated a grocery store since July 1999. The records provided for audit were severely limited. Based on its visual observation of the store, the Sales and Use Tax Department (Department) estimated that 80 percent of the merchandise sold represented taxable merchandise, such as beer, cigarettes, and soda. The percentage of reported taxable to total sales was much lower, about 45 percent. Also, the Department computed markups using the gross sales and cost of goods sold figures recorded on petitioner's federal income tax returns (FITR's) for 2003, 2004, and 2005 of 64.55,

59.45, and 57.23 percent, respectively. The Department considered these markups to be much higher than expected, which raised questions about whether recorded purchases might be understated. Because of these concerns, the Department concluded that additional investigation was warranted, but, since it did not consider the recorded purchase information reliable, it initially used an analysis of bank deposits to establish audited sales. Using bank deposits, with various adjustments detailed in the D&R and an estimated 80 percent taxable to total sales ratio, the Department computed an understatement of $283,129. In the petition for redetermination, petitioner contended that the amount of audited total sales based on bank deposits was excessive because the funds deposited in the bank included loans and lottery sales for which the Department had not made adjustments. Petitioner provided no documentation regarding loans. Nevertheless, since petitioner had made substantial lottery sales and the Department was unable to determine what portion of those lottery sales had been deposited into the business bank account and since the taxable to total sales ration the Department had used was based only on a visual observation (and could be incorrect), the Department decided to establish audited taxable sales on a markup basis.

As a result of the limited records, some estimates were necessary in the markup computations, as explained below. To establish the audited percentage of taxable to total merchandise purchases of 68.94 percent, the Department prepared a purchase segregation test using purchase invoices for the third quarter of 2006 (3Q06). It applied the 68.94 percent to the amounts of purchases recorded on FITR's to establish the amount of recorded purchases that represented taxable merchandise. To address its concern that the recorded purchases were understated, the Department added $12,000 each year to account for estimated cash purchases of taxable merchandise, and petitioner did not dispute that estimate. The Department then reduced the amounts of audited taxable purchases by 1 percent for pilferage to compute the audited cost of taxable goods sold. Since petitioner could not provide all its purchase invoices for a full purchasing cycle, the Department concluded it did not have adequate information to perform a shelf test. Instead, the Department compared the audited cost of taxable goods sold for 3Q06 to reported taxable sales for that quarter to compute an audited markup of 40 percent. Using that markup and audited cost of taxable goods sold, the Department computed audited taxable sales, which it compared to reported taxable sales to compute percentages of understatement of

STATE BOARD OF EQUALIZATION
SALES AND USE TAX APPEAL

about 92 percent for 2004, 67 percent for 2005, and 78 percent overall. It applied those percentages to reported taxable sales to compute an understatement of reported taxable sales of $184,866.

Petitioner contends that the audited understatement is excessive. Petitioner asserts that the audited markup should be reduced from 40 percent to about 20 percent and that an adjustment should be made for tax it paid on purchases of merchandise it resold.

The D&R expresses concern about the audited percentage of taxable to total merchandise purchases and the audited markup. Because of those concerns, which are associated with the lack of records available for the audit period, the D&R recommended that the Department conduct a reaudit, using current selling prices and current costs to establish the audited markup.[1] The D&R recommended that the Department use current purchase invoices, if they appear complete, to compute the audited percentage of taxable to total recorded merchandise purchases. The D&R also recommended that the Department discuss the issue of self-consumption with petitioner and make an adjustment if warranted. In addition, the D&R recommends that the Department make an adjustment for tax-paid purchases resold if petitioner provides purchase invoices *from the audit period* to show it paid sales tax reimbursement on its purchases of taxable merchandise during the audit period.[2]

During the reaudit, the Department performed a shelf test using purchase invoices dated in March and May of 2009 and selling prices from June 2009 to compute an audited markup of 29.25 percent. It also used purchase invoices for the fourth quarter 2008 to conduct a purchase segregation test to compute an audited percentage of taxable to total recorded merchandise purchases of 84.02 percent. The Department made no adjustment for self-consumption or tax-paid purchases resold in the reaudit because petitioner stated there was no self-consumption of taxable merchandise, and it did not provide any purchase invoices to document tax-paid purchases resold during the audit period.

Using the markup of 29.25 percent and the percentage of taxable to total recorded merchandise purchases of 84.02 percent, along with the estimated amount of unrecorded purchases of taxable

---

[1] Petitioner stated at the appeals conference that its purchase invoices for current periods are reasonably complete.
[2] At the appeals conference, petitioner provided invoices showing sales tax reimbursement paid on purchases of taxable merchandise for periods outside the audit period.

STATE BOARD OF EQUALIZATION
SALES AND USE TAX APPEAL

merchandise of $12,000 per year, the Department computed an understatement of $226,819, which was greater than the $184,866 established in the first reaudit, but less than the $283,129 established in the audit. Petitioner has not provided evidence to show that additional adjustments are warranted. Since petitioner did not provide adequate records for the audit period, the Department used records from current periods, as we recommended in the D&R. We note that, at the appeals conference, petitioner stated that its purchase invoices are reasonably complete for current periods and that its markup had remained about the same for several years. Petitioner has provided no evidence to show that the markup or percentage of taxable to total merchandise purchases was different during the audit period, for which minimal records were provided. We find that the Department has used the most reliable records available to establish the audited understatement, and there is no basis for further adjustment.

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

The Department imposed the 10-percent negligence penalty because petitioner did not maintain formal books and records; petitioner did not maintain sales tax worksheets to show how reported figures were computed; and a substantial amount of merchandise purchases were not recorded. Petitioner disputes the penalty on the grounds that it did, in fact, have sales journals and purchase journals, and it has done a better job of reporting since the audit was completed.

Petitioner has acknowledged that the recorded amount of taxable merchandise purchases was understated by $12,000 each year. We find that the substantial amount of unrecorded merchandise purchases is evidence of negligence in recordkeeping. Petitioner's failure to provide sales journals and purchase journals is also evidence of negligence in recordkeeping. While petitioner states that it did maintain those journals, it did not provide them during the audit or during the first or second reaudits. Even if petitioner provided them now, their existence would not be sufficient evidence to conclude that there was no negligence. We note that the audited understatement of reported taxable sales is $226,819, which represents a percentage of understatement of 96 percent in comparison to reported taxable sales of $236,032. That understatement is substantial both in absolute amount and in relation to reported figures. We find that an understatement of almost 100 percent, the severely limited records, and the understatement of recorded taxable purchases of at least $12,000 per year, are all

evidence that petitioner did not exercise due care in recordkeeping or reporting. We find that the understatement was the result of negligence, and the penalty was properly applied.

As a separate comment, while it would not alter our conclusion regarding negligence, we note that we are not convinced that petitioner has been reporting more accurately since the audit, as it states. For the 18-month period after the audit period, petitioner's reported taxable sales averaged $23,622 per quarter, which is still much lower than the average established in the most recent reaudit of $38,571 ($462,850 ÷ 12).

OTHER DEVELOPMENTS

None.

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

STATE BOARD OF EQUALIZATION
SALES AND USE TAX APPEAL

MARKUP TABLE

Percentage of taxable vs. nontaxable purchases	84.02%
Mark-up percentages developed	29.25%
Self-consumption allowed in dollars	None*
Pilferage allowed in dollars	$2,266 for 2004 & 2005
Pilferage allowed as a percent of total purchases	1%

* Petitioner stated there was no self-consumption.