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:	)	
SMOKE RINGS, INC., dba Smoke 4 Less	)	Account Number: SR X AR 100-412161 Case ID 391126
Petitioner	)	Lancaster, Los Angeles County

Type of Business: Tobacco stores

Audit Period: 6/29/04 – 9/30/06

Item	Amount in Dispute	
Understated taxable sales	$99,973	
Unreported sales of other tobacco products	$438,488	
	Tax	Penalty
As determined	$30,680.41	$3,068.07
Adjustments: Sales and Use Tax Department	-817.74	-81.82
Appeals Division[1]	36,175.26	3,617.54
Proposed redetermination	$66,037.93	$6,603.79
Amount concurred in	-21,614.90	-6,603.79[2]
Protested	$44,423.03	$0.00
Proposed tax redetermination	$66,037.93	
Interest through 1/31/11	32,647.66	
Negligence penalty	6,603.79	
Total tax, interest, and penalty	$105,289.38	
Payment	-8,000.00	
Balance Due	$97,289.38	
Monthly interest beginning 2/1/11	$338.55	

This matter was scheduled for Board hearing on May 27, 2009, but was postponed so that the Sales and Use Tax Department (Department) could review new information provided by the Board's Investigations Division regarding additional purchases of other tobacco products made by petitioner that were not accounted for in the audit of petitioner. The Department prepared a reaudit as discussed

[1] Increase asserted by Sales and Use Tax Department pursuant to Revenue and Taxation Code section 6563.
[2] At the appeals conference, petitioner specifically conceded that it was negligent. Thus, it is undisputed that the negligence penalty was properly imposed.

below under "Other Developments." The matter was then rescheduled for Board hearing on July 15, 2010, but petitioner waived its appearance at the 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 a Board hearing because it had new documentation to present to the Board. This matter was rescheduled for Board hearing on November 17, 2010, but petitioner again waived its appearance, and was thus informed that this matter would be presented to the Board for decision without oral hearing. Subsequently, petitioner's representative contacted the Board Proceedings Division to request that this matter again be placed on the oral hearing calendar.

UNRESOLVED ISSUE

Issue: Whether petitioner has established that it is entitled to additional allowance for theft loss. We conclude that no further allowance is warranted.

During the period at issue, petitioner operated as many as six stores – four in Lancaster, one in Castaic, and one in Palmdale – selling cigarettes and other tobacco products. Four of the stores were sold during the audit period. The Department noted that gross receipts reported on petitioner's 2005 federal income tax return exceeded total sales reported on petitioner's sales and use tax returns for 2005 by $380,858. Also, using sales and costs recorded on petitioner's general ledgers, the Department computed overall book markups of 5.202 percent for 2004, -26.588 percent for 2005, and -0.974 percent for the first three quarters of 2006. Since a negative book markup means that a person is selling goods below cost and since petitioner reported different amounts on its sales and use tax returns compared to its income tax returns, the Department concluded that petitioner's reported sales were substantially understated. The Department decided to establish audited sales on a markup basis, and it conducted a shelf test to calculate that petitioner's weighted mark up was 12.451 percent. The Department added this mark up to recorded taxable merchandise cost for the audit period, adjusted for a documented theft of $148,924 in 2005 based on a police report, plus one percent shrinkage. The audited taxable merchandise sales were compared with reported taxable merchandise sales to compute audited understated taxable sales of $367,683.

Petitioner contended that it was entitled to an additional theft loss of $98,752, for a theft at its

Palmdale location on February 27, 2006. We found that there was a documented theft on that date, but we concluded that the requested adjustment was unreasonable. We recommended, instead, an adjustment of $7,500, which represents approximately one month's recorded purchases for that location, an amount we consider to be a reasonable amount of inventory to have had on hand at the Palmdale location on February 27, 2006. We also recommended that self consumption of $100 per month be allowed. These adjustments reduced the understated taxable merchandise sales to $343,971.

We also found that the loss petitioner suffered as a result of the theft on February 27, 2006, included cash of $2,100 and cost of repairs and damages of $248. These losses have no effect on the measure of tax due, so with these losses plus the $7,500 already allowed, we calculated that petitioner still contends it is entitled to an additional theft loss of $88,904 ($98,752 - $7,500 - $2,100 - $248), which equates to a measure of taxable sales of $99,973.44 ($88,904 x 1.12451). Petitioner explains that the unusually large volume of merchandise on hand at the time of the theft was the result of one of its periodic bulk purchases at the time of the alleged theft, for distribution to several of its locations. Petitioner notes that the narrative of the police report suggests the suspects knew the routine of the store, which is consistent with the nature and timing of the theft.

The Department observed the Palmdale location and concluded that its storage capacity was inadequate for the amount of merchandise reported to have been on hand at the time of the theft. Further, from our review of the audit workpapers, the Palmdale location was petitioner's least busy store, based on recorded sales and purchase amounts. We also note that the requested adjustment for theft of $96,404 ($98,752 - $2,100 - $248) is greater than petitioner's average recorded monthly purchases for the first three quarters of 2006 for all of its locations combined, $86,349. We find it unlikely that petitioner would have had that much inventory at this store. Further, petitioner sold this location effective one day after the alleged theft.[3] Generally, businesses attempt to keep minimal inventories when they are being sold. For all the above reasons, we do not accept the amount for the theft loss reflected on the Personal Property Inventory Forms and conclude that no further adjustment is warranted.

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[3] The Board's records show petitioner's Palmdale location was sold effective February 28, 2006.

STATE BOARD OF EQUALIZATION
SALES AND USE TAX APPEAL

OTHER DEVELOPMENTS

Prior to the Board hearing scheduled on May 27, 2009, the Investigations Division found, and informed the Department, that petitioner had purchased other tobacco products from an out-of-state supplier, The House of Oxford, which were not included in the audit. Based on its review, the Department concurred with the findings of the Investigations Division. Thus, in a second reaudit, the Department used the additional purchases to compute taxable sales of other tobacco products of $438,488. This adjustment increased the audited taxable measure from the first reaudit measure of $361,971 to the second reaudit measure of $800,459 ($343,971 for unreported taxable sales, $438,488 for the separately stated sales of other tobacco products established in the second reaudit, $13,800 for self consumption of cigarettes, and $4,200 for unreported taxable cigarette rebates) or an increase in tax from $29,862.67 to $66,037.93. By letter dated December 21, 2009, the Department asserted the increase in tax and penalty pursuant to Revenue and Taxation Code section 6563. Petitioner has not specifically protested the separately stated amount of unreported taxable sales of other tobacco products. The evidence shows that these purchases were not recorded in petitioner's books and records, and in the absence of arguments or evidence regarding this issue, we recommend no adjustment to the separately stated amount of unreported taxable sales of other tobacco products.

Summary prepared by Rey Obligacion, Retired Annuitant

MARKUP TABLE

Percentage of taxable vs. nontaxable purchases	100%*
Mark-up percentage developed	12.451%
Self-consumption allowed in dollars	$13,800
Self-consumption allowed per month	$100 per month
Pilferage allowed in dollars	$20,709
Pilferage allowed as a percent of total purchases	1%
Theft allowed in dollars as supported by police reports	$156,424

* Unreported taxable sales were established on analysis of taxable purchases only. Petitioner did claim exempt food sales of $2,785, for the audit period while reporting taxable sales of $1,881,073 on his sales and use tax returns. Based on petitioner's sales and use tax returns, exempt sales represent 0.148 percent of reported taxable sales.