

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:)
STORE2DOOR, INC.) Account Number: SR Y AC 100-049715
Petitioner) Case ID 352179
Burbank, Los Angeles County

Type of Business: Two convenience stores

Audit period: 01/01/03 – 12/31/05

<u>Item</u>	<u>Disputed Amount</u>
Unreported sales, Burbank store	\$962,954
Unreported sales, Van Nuys store	\$ 1,017
Purchases of fixed assets subject to use tax	\$ 999
Unreported cigarette rebates	\$ 18,246
Negligence penalty	\$ 8,112

	<u>Tax</u>	<u>Penalty</u>
As determined:	\$90,695.82	\$9,069.62
Adjustment - Sales and Use Tax Department	11,718.15	1,171.76
- Appeals Division	<u>-21,298.60</u>	<u>-2,129.82</u>
Proposed redetermination, protested	<u>\$81,115.37</u>	<u>\$8,111.56</u>
Proposed tax redetermination	\$ 81,115.37	
Interest through 10/31/10	43,177.19	
Negligence penalty	<u>8,111.56</u>	
Total tax, interest, and penalty	\$132,404.12	
Payments	- 406.26	
Balance Due	<u>\$131,997.86</u>	
Monthly interest beginning 11/1/10	<u>\$ 470.80</u>	

UNRESOLVED ISSUES

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

Petitioner operates two convenience stores, one in Burbank, which was open for the entire audit period, and one in Van Nuys, which opened on June 14, 2005. A substantial percentage of the merchandise sold is delivered by petitioner to its customers. The Burbank store also made taxable sales of hot food products, and it made sales to the corporate officers at cost. In its preliminary review,

1 the Sales and Use Tax Department (Department) computed negative markups (that is, sales below cost)
2 for each year of the audit period using petitioner's recorded costs and reported sales. The Department
3 considered the negative markups to be evidence that reported taxable sales were understated and
4 decided to establish audited taxable sales on a markup basis.

5 For each store, the Department conducted shelf tests to compute audited markups, using costs
6 from purchase invoices and selling prices determined by scanning items at the register. The
7 Department computed different markups for store sales and delivery sales because it found that, for
8 certain product categories, the markups for delivery sales exceeded the markups for store sales. To
9 establish the audited cost of taxable store sales and taxable delivery sales for each store, the
10 Department first conducted segregation tests to determine the percentage of taxable to total
11 merchandise purchases. Then, the Department used cash register tapes to compute the percentages of
12 store sales and delivery sales for each store. After computing the cost of taxable merchandise sold in
13 the store and in delivery sales for each store, the Department reduced the merchandise sold in the
14 Burbank store by \$18,000, an estimated amount of merchandise sold to the corporate officers at cost,
15 and reduced the costs for store sales and delivery sales for both stores by an estimated amount of losses
16 due to pilferage, computed at two percent. The Department used the audited costs of taxable
17 merchandise sold in the store and in delivery sales by each store and the related audited markups to
18 compute audited taxable sales other than hot food. Then, the Department added audited hot food sales
19 (sold only in the Burbank store), which it computed at 4.13 percent of total sales based on a review of
20 cash register tapes. Finally, the Department computed taxable delivery charges for each store using
21 percentages computed from a review of cash register tapes.¹ To establish audited taxable sales for
22 each store for the audit period, the Department added audited taxable store sales, taxable delivery sales,
23 and taxable delivery charges for both stores. For the Burbank store, it also added taxable sales at cost
24 to corporate officers and taxable hot food sales. The Department compared audited and reported
25 taxable sales to establish understatements of reported taxable sales for each store.

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28 ¹ Since petitioner charged sales tax reimbursement on its delivery charges whether the sales were taxable or exempt, the Department concluded, and petitioner agreed, that all the delivery charges were subject to tax.

1 Petitioner contends that the amounts of unreported sales are excessive. With respect to
2 petitioner's argument concerning a clerical error on audit schedule 1R-12A-1, we recommended a
3 reaudit in the D&R, and the Department has made the necessary adjustments in its reaudit.

4 Petitioner asserts that the Department should rely on petitioner's books and records instead of
5 using the markup method to compute audited sales. Since retailers do not routinely sell merchandise
6 for less than their cost, we find the negative markups computed using recorded costs and reported
7 taxable sales to be strong evidence that petitioner's books and records do not accurately reflect
8 petitioner's taxable sales. Therefore, we conclude it was appropriate for the Department to utilize an
9 alternate method (the markup audit approach) to establish audited taxable sales.

10 Petitioner raises several issues regarding the computed amounts of taxable sales. Petitioner
11 argues that the audited amounts of taxable delivery charges are excessive. The audited ratio of
12 delivery charges to total sales was based on a review of cash register tapes dated after the audit period,
13 which were the only cash register tapes petitioner provided during the audit. Petitioner asserts that for
14 the Burbank store, the delivery charge was lower during the audit period than it was after the audit
15 period. For the Van Nuys store, petitioner asserts that the store did not begin making deliveries until
16 2006, after the audit period. In the D&R, we recommended that, as part of the reaudit, the Department
17 review additional documentation to be provided by petitioner with respect to the delivery charges.
18 During that reaudit, petitioner provided cash register tapes for three days, March 31, 2003, May 18,
19 2004, and September 1, 2005. However, the cash register tapes did not provide evidence to support
20 petitioner's contention because they did not show information regarding the delivery charges.
21 Nevertheless, the Department made an adjustment to reflect a reduction in the delivery charge from the
22 \$3.99 used in the audit to the \$2.99 stated by petitioner as the delivery charge for the Burbank store
23 during the audit period. Since petitioner did not provide evidence that there were no delivery sales for
24 the Van Nuys store in 2005, the Department did not delete the audited delivery charges for that store,
25 but it did make the same adjustment made for the Burbank store, reducing the audited delivery charge
26 from \$3.99 to \$2.99.

27 Petitioner also contends that the audited percentage of delivery sales should be reduced for the
28 Burbank store and that the additional measure for delivered sales should be eliminated for the Van

1 Nuys store based on its contention that deliveries were not made by the Van Nuys store during the
2 audit period. During the reaudit, petitioner did not provide convincing evidence to support lower
3 percentages of delivery sales (as noted above, the cash register tapes provided by petitioner did not
4 show information regarding the delivery charges). Consequently, the Department made no adjustment
5 to the audited percentage of delivery sales for either store.

6 In response to petitioner's arguments and upon review of additional documentation during the
7 reaudit, the Department made several other adjustments. The Department reduced the percentage of
8 taxable to total sales from 69.35 to 64.01 percent for the Burbank store and used that percentage for the
9 Van Nuys store as well. Based on its review of purchase invoices dated in June and July 2006, the
10 Department adjusted some of the costs used in the shelf tests, which resulted in reductions of the
11 audited markups. The Department also made adjustments to address petitioner's argument that the
12 markups were weighted incorrectly because the shelf tests do not include some of petitioner's most
13 popular products and because the purchase segregation test was inaccurate. As we recommended, to
14 address the argument that the markups were lower in the early portion of the audit period, the
15 Department has reduced the markups for the Burbank store by 2 percent per year for 2003 and 2004.

16 Petitioner asserts the audit report incorrectly states that there is a material discrepancy between
17 the gross receipts reported on the federal income tax returns and total sales reported on the sales and
18 use tax returns because the difference represents sales tax reimbursement. Although, based on our
19 reconciliation of the total sales figures, we find that the federal income tax returns do not disclose an
20 understatement of sales, the issue is irrelevant here because the audited understatement was not based
21 on a comparison of income tax and sales tax returns.

22 We find that all supported adjustments have been made, and that no further reductions are
23 warranted.

24 **Issue 2:** Whether adjustments are warranted to the purchases of fixed assets subject to use tax.
25 We recommend no further adjustment.

26 During the audit, the Department scheduled purchases of fixed assets from petitioner's general
27 ledger. Since petitioner did not provide purchase invoices to show that it had paid tax to the Board or
28 tax reimbursement to its vendors with respect to those purchases, the Department concluded that all the

1 purchases were subject to use tax. Based on documentation provided during the reaudit, the
2 Department has reduced the purchases of fixed assets subject to use tax from \$9,799 to \$999.
3 Petitioner's records do not include a vendor name for either of the remaining purchases so that the
4 Department could determine if either vendor was a California retailer, and petitioner has not otherwise
5 shown that the purchases were subject to sales tax or that it paid use tax with respect to the two
6 remaining purchases. Thus, we find no further adjustments are warranted.

7 **Issue 3:** Whether the rebates petitioner received from cigarette manufacturers are subject to tax.
8 We find that they are.²

9 Petitioner received rebates from RJ Reynolds, and the Department scheduled the total amount
10 of cigarette rebates received from petitioner's records. The Department regarded the rebates as taxable
11 gross receipts. Petitioner contends that the rebates are not taxable because they represent purchase
12 discounts rather than gross receipts.³

13 The contracts in this case represent a three-party arrangement, in which petitioner has
14 purchased the cigarettes from a vendor, but received the rebate from the manufacturer, the third party.
15 The audit workpapers include copies of two contracts between petitioner and RJ Reynolds, which
16 show that, as a condition of receiving the rebates, petitioner was required to reduce the retail selling
17 prices of the cigarettes by an equivalent amount. Thus, the rebates represent taxable gross receipts.

18 **Issue 4:** Whether petitioner was negligent. We conclude that it was.

19 The Department imposed the negligence penalty because the recorded costs exceeded reported
20 taxable sales for each year of the audit period and because the understatement was significant in
21 relation to the reported measure of tax. Petitioner disputes the penalty because it believes most of the
22 determined tax is not due.

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25 ² We concluded in the D&R that the rebates were not subject to tax, but we reversed that decision in an SD&R, upon further
review of the evidence in response to a Request for Reconsideration filed by the Department.

26 ³ One of petitioner's arguments is that subdivisions (d)(4)(A) and (d)(4)(B) of California Code of Regulations, title 18,
27 section 1671.1 support its position that the rebates represent purchase discounts. We note that the regulation does not apply
28 to this appeal because the terms of the regulation limit its application to periods commencing on and after October 1, 2007.
Even if the regulation were applicable, however, we find that the subdivisions cited by petitioner do not support its position
because each subdivision relates to situations for which the retailer can document that it was not required to reduce its
selling prices to obtain the rebate, which is not the case here.

MARKUP TABLES

BURBANK

Percentage of taxable vs. nontaxable purchases	64.01%
Percentages of sales: in store/delivery	50.07%/49.93%
Mark-up percentages developed: in store Delivery	<u>2003</u> <u>2004</u> <u>2005</u> 38.93% 40.93% 42.93% 52.88% 54.88% 56.88%
Self-consumption allowed in dollars	None*
Pilferage allowed in dollars: in store delivery	\$11,221 for the audit period \$11,188 for the audit period
Pilferage allowed as a percent of total purchases	2% for both in store & delivery

* No adjustment was made for self-consumption because taxpayer stated no merchandise was withdrawn from inventory for personal use. However, the audited cost of taxable goods sold for the Burbank store was reduced by \$18,000 for the audit period for sales of merchandise to corporate officers at cost. The sales of \$18,000 were then added to audited taxable sales in the store.

VAN NUYS

Percentage of taxable vs. nontaxable purchases	64.01%
Percentages of sales in store/delivery	76.02%/23.98%
Mark-up percentages developed: in store/delivery	42.93%/56.88%
Self-consumption allowed in dollars	None**
Pilferage allowed in dollars	\$930 for 2005
Pilferage allowed as a percent of total purchases	2% for both in store & delivery

** No adjustment was made for self-consumption because taxpayer stated no merchandise was withdrawn from inventory for personal use. The audit workpapers indicate that the Van Nuys store did not make sales to corporate officers.