STATE BOARD OF EQUALIZATION
CIGARETTE AND TOBACCO PRODUCTS TAX APPEAL

CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION BOARD HEARING SUMMARY

In the Matter of the Petitions for Redetermination Under the Cigarette and Tobacco Products Tax Law of: LOH SUN INTERNATIONAL, INC., KENT LA, NANCY LA, AND JOHN LA Petitioner	Account Number: CR ET 02-002372 Case ID's 480987, 480989, 506428 San Gabriel, Los Angeles County

Type of Business: Distribution of cigarettes

Liability periods: 01/01/01 – 06/30/03 (480987)
07/01/03 – 07/31/03 (480989 and 506428)

Item	Disputed Amount
Unreported distributions of cigarettes	47,115,800 sticks (480987) 1,382,000 sticks (480989) 3,060,000 sticks (506428)
Fraud penalties	$512,385 (480987) $ 15,029 (480989) $ 33,278 (506428)

	480987	480989	506428
Tax as determined and protested	$2,049,540.00	$ 60,117.00	$133,110.00
Interest through 03/25/13	1,767,820.01	47,091.58	87,329.09
Fraud penalty	512,385.00	15,029.25	33,277.50
Total tax, interest, and penalty	$4,329,745.01	$122,237.83	$253,716.59
Payments	- 134,345.62	00.00	- 73,654.38
Balance Due	$4,195,399.39	$122,237.83	$180,062.21
Monthly interest beginning 04/26/13	$ 9,575.97	$ 300.59	$ 297.28

This is an appeal that is covered by Revenue and Taxation Code section (Section) 40. Therefore, after the Board has made a determination in this matter, a written opinion that, among other things, sets forth the relevant factual findings and the legal analysis on which that determination is based must be published on the Board's website within 120 days from the date the Board renders a final decision in this matter. Accordingly, the Board may wish to consider the following two options:

(A) The Board could follow its usual practice in business tax appeals, in which it typically votes to resolve the appeal on the day of the hearing. Under the usual practice, a notice of the Board's determination will be mailed within 45 days of the date of the Board's vote, and the

30-day period for the filing of a Petition for Rehearing (PFR) would begin on the date the notice is mailed. If a PFR is not filed, the Board's determination will become final and its decision will be rendered at the expiration of the 30-day PFR period. Unless the Board specifically directs that it desires to issue a precedential (Memorandum Opinion) decision in this matter, staff would then expeditiously bring back a proposed (nonprecedential) Summary Decision that complies with Section 40 for the Board's approval on a later calendar. The adopted decision will be published timely on the Board's website. If a PFR is filed, no decision will be rendered until the conclusion of the petition for rehearing process.

(B) The Board could inform staff of its tentative determination and direct staff to prepare a proposed Summary Decision (or Memorandum Opinion) that reflects the tentative determination for Board approval as soon as practicable. Under this option, the Board would hold any determination of the appeal in abeyance until it has the opportunity to consider the proposed decision. The Board's later vote to adopt the decision would also constitute its vote to resolve the appeal, and within 45 days a notice of decision would be mailed. The 30-day PFR period would begin running when the notice of the Board's determination was mailed. If no PFR is filed, the Summary Decision (or Memorandum Opinion) would then be timely posted on the Board's website pursuant to Section 40.

We also note that petitioner could request during the oral hearing that the Board take Option B above and defer its vote to determine the appeal until it adopts a Summary Decision (or Memorandum Opinion). Such a request would, of course, defer resolution of the appeal and interest would continue to accrue. On the other hand, petitioner may prefer that the Board follow its usual practice in business tax appeals, which typically would result in a vote to resolve the appeal on the day of the hearing, thus accelerating the resolution process, but potentially requiring petitioner to file a PFR before it sees the content of the Summary Decision (or Memorandum Opinion) adopted by the Board.

The Board heard this matter on April 26, 2012. The hearing focused on John La's arguments that he was not a partner in the business, that he was not involved in the partnership's unreported distribution of cigarettes and counterfeit cigarettes, and that funds transferred in and out of his bank account were not related to the purchase or sale of cigarettes by the partnership. The Board found that John La was a partner and that the partnership is liable for the tax and penalties included in each of the three Notices of Determination at issue. John La filed a timely petition for rehearing (PFR), which was scheduled on the Consent calendar in September 2012. The PFR was pulled from the Consent Agenda at the request of Member Steel, and the Board granted the PFR in November 2012.

STATE BOARD OF EQUALIZATION
CIGARETTE AND TOBACCO PRODUCTS TAX APPEAL

UNRESOLVED ISSUES

Issue 1: Whether Loh Sun International, Inc., Kent La, Nancy La, and John La operated as a partnership liable for unreported distributions of cigarettes in California. We conclude that they did operate as a partnership liable for the unreported distributions.

Loh Sun International, Inc. (Loh Sun) operated as an importer of Chinese-manufactured cigarettes and as a licensed wholesale distributor of cigarettes under Cigarette Distributor's License CR ET 002-000922 from December 1, 1988, through November 7, 2007. Loh Sun's corporate officers are Kent La (president), Nancy La (secretary), and John La (vice president). Kent La and Nancy La are married, and John La is their son. The Investigations and Special Operations Division (ISOD) found that, separate from the sales activities Loh Sun performed on its own behalf, Loh Sun and its corporate officers constituted a partnership operating as an unlicensed distributor of cigarettes and making sales of untaxed cigarettes in California. ISOD thus concluded that the partnership is liable for the taxes, interest, and penalties at issue, with the partners jointly and severally liable.

Based on documents discovered when ISOD and special agents with the Bureau of Alcohol, Tobacco, and Firearms (ATF) executed a search warrant on a customer of Loh Sun, ISOD determined that Loh Sun did not include the cigarette excise tax due on distributions of cigarettes to that customer. ISOD noted that the majority of the invoices to the customer were generic invoices or were handwritten on pieces of lined paper rather than on Loh Sun's standard invoices. Many of the seized invoices specified that payment for the purchase was to be deposited into the personal bank accounts of Kent La, Nancy La, or John La rather than Loh Sun's corporate bank account. ISOD also became aware of various other shipments of unstamped cigarettes to Loh Sun's business address and, along with investigators from the California Highway Patrol, it executed a search warrant in July 2003 on Loh Sun's business location and the corporate officers' residence, during which ISOD discovered unstamped cigarettes and counterfeit California tax stamps located in the basement of the Loh Sun business location. Other evidence as described in the D&R supports that there was a scheme to avoid payment of tax. During the search of the corporate officers' residence, ISOD found rental agreements for two storage units, one of which was rented to John Lim, with Nancy La named as a person with access to it. Although ISOD found unstamped counterfeit Marlboro- and Newport-brand cigarettes in

both storage units, it concluded that only the unit Nancy La could access was controlled by the partnership. That unit held approximately 3,060,000 sticks of cigarettes.

In September 2004, the Los Angeles County District Attorney's office filed criminal complaints against Kent La, Nancy La, and John La. Nancy La pled no contest to all charges against her. The charges against John La were dropped as part of Nancy La's agreement to plead no contest. Kent La was out of the country at the time the search warrant was executed and was a fugitive at the time the D&R was issued.

During the search of Loh Sun's business premises, ISOD found that the business of Loh Sun was conducted on the first and second floors of the business location, but that an inventory of counterfeit cigarettes was located in the basement of the building, separate from any legitimate inventory and hidden from inspections. ISOD found that purchases of this counterfeit inventory did not flow through Loh Sun's books, that payment for the purchases was made from accounts other than Loh Sun's, and that many customers were instructed to pay for sales of this inventory directly to personal bank accounts, rather than making payment to Loh Sun. ISOD concluded that Loh Sun was a partner in the partnership because some of the illegal activity occurred in the basement of Loh Sun's business location.

Petitioner contends that no partnership existed and that, even if so, there is no evidence that the storage unit located in San Gabriel belonged to the partnership since the rental agreement only allowed Nancy La access to the storage unit. John La contends he had no official duties for Loh Sun and was not a partner in any conspiracy to sell illegal or untaxed cigarette products. He asserts that ISOD is attempting to attribute to him the illegal acts of his mother. John La explains the funds flowing in and out of his bank account by the assertion that they either relate to a day trading stock market business he operated or represent personal loans from his mother to cover margin calls on some of his investments. John La has also argued that his mother was secretly depositing funds from the cigarette distribution business into his account.

Nancy La has admitted to selling unstamped Marlboro-brand cigarettes to customers in California, and she used Loh Sun's business location to conduct those activities. Considering the nature of her position in Loh Sun, the corporation must be regarded as having knowledge of her

STATE BOARD OF EQUALIZATION
CIGARETTE AND TOBACCO PRODUCTS TAX APPEAL

activities on its premises, and having consented to them. We therefore conclude that Nancy La and Loh Sun were in a partnership that operated as an unlicensed distributor of cigarettes. The evidence shows that Kent La used his personal bank account to hide proceeds obtained from the partnership's unreported distribution of cigarettes and his involvement in the purchase and importation of counterfeit domestic-branded cigarettes. We therefore find that Kent La was also part of the partnership.

Regarding John La, we noted that payments for the counterfeit and unstamped cigarettes were sometimes made to John La's personal bank account, and at least one wire transfer for $180,000 was made from John La's personal bank account to a Hong Kong tobacco company from whom the partnership made purchases of counterfeit and unstamped cigarettes. Accordingly, we concluded that John La was also a partner in the scheme, and that one of his roles in the partnership was to receive proceeds from unreported distributions of cigarettes and to channel those funds to others. We found John La's contentions that all relevant acts were perpetrated solely by Nancy La and that the flow of money through his account was due to loans and secret deposits made by Nancy La to be unsupported by the evidence and without merit.

As stated previously, at the hearing held on April 26, 2012, petitioner focused on its argument that John La was not a partner and should not be held responsible for the liabilities at issue. The Board found he was a partner, and John La filed a PFR on June 5, 2012, asserting that he had obtained newly discovered relevant evidence to support his argument that he was not a partner in the business. He submitted evidence that the payment of $180,000 to a Hong Kong tobacco company, previously regarded as a payment for the purchase of cigarettes, was in fact related to stock investments. However, as explained more fully under "Post Hearing Developments," we have received information showing that the evidence is not authentic. Mr. La also provided approximately 200 pages of handwritten cigarette sales invoices issued by the partnership, which he described as all of the invoices obtained by the Board in its investigation of the partnership. Since the invoices he submitted do not contain instructions for purchasers to deposit funds directly into his bank account, Mr. La argues that they controvert the Board's finding that he was a partner who received proceeds from unreported distributions of cigarettes and channeled those funds to other bank accounts.

STATE BOARD OF EQUALIZATION
CIGARETTE AND TOBACCO PRODUCTS TAX APPEAL

However, the Board's records from its investigation of the partnership include sales invoices that were not included in Mr. La's submission, and when we explained to Mr. La that some of those invoices *did* contain instructions to deposit funds directly into his bank account, he responded that there were fewer than 10 invoices that contained such instructions. On that basis, Mr. La changed his request from a request for relief from all liability to a request that his liability be limited to the portion of the partnership's tax liability related to the invoices that contained instructions to deposit the funds directly in his account. In other words, Mr. La effectively conceded his participation in the partnership to the extent of the invoices that show such involvement. Since all partners are jointly and severally liable for all the debts and obligation incurred by the partnership (Corp. Code, § 16306, subd. (a)), we find Mr. La is liable, along with the other partners for the entire liability.

In sum, we find that Loh Sun, Kent La, Nancy La, and John La were partners in a partnership that operated as an unlicensed distributor of cigarettes in California and that they are jointly and severally liable for the tax due on the untaxed tobacco products distributed by the partnership in California. We find further that the cigarettes seized during the execution of the search warrant were owned by the partnership, and that the partnership distributed these cigarettes since distribution includes the use or consumption of untaxed cigarettes in this state, which here includes the partnership's storage of the cigarettes. (Rev. & Tax. Code, § 30009 (the keeping or retention of cigarettes by a *licensed* distributor for the purpose of sale is excluded from the definition of "storage or use," but this exclusion is not applicable here because the partnership was not licensed).)

Regarding the cigarettes found in the storage unit, we note that they were the same type of illegal cigarettes that the partnership was importing and selling through the basement of Loh Sun's business location, which links the cigarettes in the storage unit with the rest of the partnership's operation. In addition, while Kent La and John La were not identified as having direct access to the storage unit, Nancy La did have access and could have removed inventory at any time. We find that ISOD properly regarded the inventory in that storage unit as belonging to the partnership.

Issue 2: Whether adjustments are warranted to the amounts of unreported distributions. We find no adjustments are warranted.

STATE BOARD OF EQUALIZATION
CIGARETTE AND TOBACCO PRODUCTS TAX APPEAL

To establish the deficiency for January 1, 2001, through June 30, 2003, ISOD used records seized during the various searches, including a partial general ledger, handwritten daily sales journals, sales invoices, shipping documents, import and customs documents, purchase invoices, bank statements and deposit slips, generic sales invoices, and inventory sheets for cigarettes. ISOD used these records to make adjustments for the tax value of stamps purchased by Loh Sun and for exempt sales. ISOD also made adjustments for duplication and scheduling errors. For the month of July 2003, ISOD established unreported distributions of 1,382,000 cigarette sticks based on generic sales invoices for that month and the number of cigarettes seized from Loh Sun's business location on July 24, 2003 (case ID 480989), and unreported distributions of 3,060,000 cigarette sticks based on the cigarettes found in the storage unit controlled by the partnership (case ID 506428).

Petitioner contends that the liabilities are overstated because: 1) no allowance was made for sales by Loh Sun, as the original importer, to 19 licensed distributors; 2) no credit was given for $247,000 in cash seized by the ATF during execution of the search warrant; 3) the civil liabilities exceed the amount of the criminal restitution order issued against Nancy La; 4) two transactions are duplicated; 5) there are no copies of invoices for certain transactions, with some items on individual invoices scheduled twice; 6) the audits include transactions that are purchases, not sales; 7) there should be a reduction for sales of cigarettes with legitimate tax stamps; and 8) an allowance of $204,450 should be made for cigarettes returned by one customer.

We find that ISOD utilized the information available to it and allowed exempt distributions of cigarettes that were documented (ISOD found that only two of the 19 customers listed by petitioner as licensed distributors were in fact licensed distributors). We find no allowance can be made for funds seized by the ATF unless the ATF releases those funds to the Board for application toward the determined liabilities, which it has not done. There is no requirement that a criminal restitution order reflect the amount of damages that might be recoverable in a civil action, and we find that order is irrelevant here, except to the extent payments made per the order are applied to the liability. We find that the duplicated transactions identified by petitioner have already been deleted from the deficiency. Regarding the unavailability of invoices and characterization of purchases as sales, we find that ISOD properly used the generic sales invoices and the number of unstamped cigarettes seized as the basis for

STATE BOARD OF EQUALIZATION
CIGARETTE AND TOBACCO PRODUCTS TAX APPEAL

determining the number of under-reported sticks, and that petitioner has offered no evidence to support further adjustments. We find further that no adjustment is warranted for sales of cigarettes with legitimate tax stamps because the audited amounts are based on the generic invoices which represent sales of cigarettes *without* legitimate tax stamps. Nor is any adjustment warranted for returned cigarettes since the subject return occurred after the periods at issue here. In sum, we find no adjustments are warranted.

Issue 3: Whether ISOD has supported fraud by clear and convincing evidence. We find that it has. [1]

ISOD imposed fraud penalties because it found that the partnership intended to commit fraud, as evidenced by Nancy La's admission that she sold unstamped cigarettes and applied counterfeit stamps, the fact that she pled guilty to several criminal charges, the seizure of significant amounts of cigarettes with no stamps or with counterfeit tax stamps, the various documents showing that petitioner intentionally concealed purchases of counterfeit domestic-brand cigarettes, the double set of records maintained by petitioner, the fact that customers were required to make payments through deposits into the personal bank accounts of Kent, Nancy, and John La, and the substantial understatement. ISOD also considered that the partners were knowledgeable regarding the applicable laws and that Loh Sun had held a Cigarette Distributor's License since December 1988 and had been audited twice before.

Petitioner contends that the fraud penalties are not supported by clear and convincing evidence. Petitioner specifically disputes the fraud penalty applied with respect to the cigarettes seized at the storage unit, arguing that the tax related to those cigarettes was based on the storage of cigarettes at an unlicensed facility rather than on the sale and distribution of cigarettes with no stamps or with counterfeit stamps. Also, petitioner states ISOD has not established that any of the partners had knowledge of the provision requiring permits not only for selling locations but also for strictly storage locations.

---

[1] Since the partnership did not file returns, in the absence of fraud the applicable statute of limitations for issuing a Notice of Determination is eight years from the date the return or report was due. (Rev. & Tax. Code, § 30207.) Since each determination here was issued within that period (the determination for January 1, 2001, through June 30, 2003, was issued in January 2009 and the two determinations for the month of July 2003 were issued in July 2009), the determinations were timely for all assessed liabilities, without regard to whether the fraud penalties are upheld.

STATE BOARD OF EQUALIZATION
CIGARETTE AND TOBACCO PRODUCTS TAX APPEAL

There is ample evidence that petitioner intentionally failed to report the tax due on distributions of cigarettes, despite the partners' thorough knowledge of the reporting and stamping requirements applicable to a distributor. The most compelling evidence of intentional underreporting are Nancy La's various admissions, the fact that she pled no contest to criminal charges for felony cigarette tax evasion, and the sale of cigarettes with no stamps or with counterfeit stamps. Petitioner's intent to evade the cigarette excise taxes is further evidenced by the partners' efforts to hide their illegal operations, concealing them in the basement of Loh Sun's business location, separate from Loh Sun's legitimate business operations, and maintaining an inventory of cigarettes with no stamps or with counterfeit stamps at an undisclosed and unlicensed location (the rented storage unit). The double set of records maintained by petitioner, one showing the legal distributions of cigarettes only and the other showing all distributions, both legal and illegal, offers additional, virtually incontrovertible, evidence of petitioner's intent to conceal the illegal activity and unreported distributions. Since we find that the partnership owned the cigarettes discovered in the storage unit (which were the same type of illegal cigarettes found in the basement of Loh Sun's business location), we find that the fraud penalties are equally applicable to the tax assessed with respect to cigarettes found in the storage unit. In sum, we find that clear and convincing evidence of fraud has been amply supplied, and that the fraud penalties were properly applied.

POST HEARING DEVELOPMENTS

In our analysis of the PFR, we noted that, in the PFR, Mr. La stated he had obtained newly discovered relevant evidence. That evidence included a letter dated December 17, 2002, entitled "Receipt of Funding" from Mr. George Chen at Citibank in Hong Kong to Blooming Jasmine Ltd. The Receipt of Funding states that, on December 17, 2002, Citibank received a wire from Mr. La in the amount of $180,000 for deposit into Mr. La's Blooming Jasmine Ltd. account for the purchase of stock and stock warrants of Pacific Century Cyberworks. In our analysis of the PFR, we did not question the authenticity of that document. However, staff from the Tax and Fee Programs Division of the Board's Legal Department has obtained additional evidence in this matter. Specifically, staff has submitted an email dated February 13, 2013, from Nigel Chu, the Customer Service Manager of Citibank, Hong Kong, stating that the December 17, 2002 letter was not sent by Citibank. The email also states the

STATE BOARD OF EQUALIZATION
CIGARETTE AND TOBACCO PRODUCTS TAX APPEAL

correct address for the bank branch in question, which indicates that the address on the letter that petitioner provided is incorrect. Based on the foregoing, we conclude that the letter is a forgery, which we now reject. This additional information does not alter our conclusions, but it does raise significant doubts regarding the credibility and veracity of Mr. La's arguments.

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

STATE BOARD OF EQUALIZATION
CIGARETTE AND TOBACCO PRODUCTS TAX APPEAL