CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION FINAL ACTION SUMMARY

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of: CHARLIE VIET NGUYEN, dba Lundy Liquor Petitioner	Account Number: SR GH 100-085495 Case ID 367213 San Jose, Santa Clara County

Type of Business: Liquor store

Audit period: 10/1/02 – 5/22/06

Item	Disputed Amount
Additional sales	$698,510
Negligence penalty	5,804
Amnesty double negligence penalty	471
Amnesty 50 percent interest penalty	401

	Tax	Penalty
As determined:	$58,042.95	$6,275.63
Less concurred	- 415.80	0.00
Balance, protested	$57,627.15	$6,275.63

Proposed tax redetermination	$58,042.95
Interest through 5/31/11	29,061.71
Negligence penalty	5,804.27
Amnesty double negligence penalty	471.36
Total tax, interest, and penalties	$93,380.29
Payments	-11,774.38
Balance Due	$81,605.91
Monthly interest beginning 6/1/11	$269.90

This matter was scheduled for Board hearing on May 24, 2011, but petitioner has waived his right to appear at a Board hearing. Accordingly, the Board Proceedings Division informed petitioner that this matter will be presented to the Board for decision without oral hearing.

UNRESOLVED ISSUES

Issue 1: Whether the determined tax is excessive. We concluded that it is not.

Petitioner operated a liquor store selling the usual merchandise, including lottery tickets and money orders, until May 22, 2006, when he closed the business. For audit, petitioner provided federal income tax returns (FITR's) for 2002, 2003, and 2004; incomplete purchase invoices; cash register tapes; bank statements; and copies of sales and use tax returns. Petitioner did not provide a purchase or disbursements journal or a check register. The Sales and Use Tax Department (Department) conducted a purchase segregation test of the second quarter 2004 (2Q04) to calculate a 92.14-percent taxable merchandise purchase ratio, which it applied to the cost of goods sold (COGS) petitioner reported on his FITR's to determine the taxable portion of the COGS petitioner reported on his FITR's. Comparing this amount to petitioner's reported taxable sales, the Department found that the taxable portion of the COGS petitioner reported on his FITR's significantly exceeded his reported taxable sales. Based on this discrepancy, the Department concluded that petitioner's reported taxable sales were understated, and decided to establish petitioner's taxable sales by the markup method.

The Department performed a shelf test using purchase invoices from January 2006 and observed selling prices posted on petitioner's shelves in February 2006, resulting in a weighted average taxable markup of 40.65 percent. The Department then adjusted the 2003 and 2004 FITR COGS by $1,440 per year for self-consumption and by one percent for pilferage, applied the 92.14 percent taxable merchandise purchase ratio to the adjusted COGS to compute audited taxable COGS, and then applied the 40.65 percent weighted average taxable markup to compute audited taxable sales of $544,676 for 2003 and $432,529 for 2004. The Department then compared audited taxable sales to reported taxable sales of $251,298 for 2003 and $263,658 for 2004. As discussed below, petitioner actually reported less than $263,658 for 2004, but based on these amounts, the Department computed understatements of $293,378 for 2003 and $168,871 for 2004, representing error rates of 116.74 percent for 2003 and 64.05 percent for 2004. The Department applied the 116.74 percent error rate to pre-2004 reported taxable sales and the 64.05 percent error rate to post-2003 reported taxable sales to compute understated taxable sales of $698,150 for the audit period, and issued a Notice of Determination for this deficiency. Compared to the $843,259 reported taxable sales for the audit period, the determined understatement represents an 82.79 percent overall error rate.

In his petition for redetermination, petitioner alleged that the FITR COGS included lottery ticket purchases of $204,608 for 2003 and $215,497 for 2004, based on Forms 1099-MISC showing commission income of $13,299.53 for 2003 and $14,007.29 for 2004 and a sales commission rate of

6.5 percent. However, petitioner did not provide detailed purchase records to support the allegation. Petitioner also states that he actually reported taxable sales of $218,446 during 2004, rather than the $263,638 reported taxable sales used by the Department in its audit calculations (meaning that, had the Department used the correct figure, the audited understatement for 2004 would have been increased by $45,192).

The Department decided to conduct a reaudit to establish petitioner's taxable merchandise purchases using a different audit method. The Department surveyed all of petitioner's 15 known vendors, but only received vendor survey documentation from Youngs Market, Bottomly Distributing, 7Up, and South Bay Beverage (collectively, "the four vendors") for 2004. The Department found that in 2Q04 petitioner made purchases of $47,805 from the four vendors and $79,770 from all vendors, and thus presumed that petitioner's purchases from all vendors were 166.87 percent of the amount from the four vendors. The Department found that petitioner made purchases of $232,465 from the four vendors in 2004, and applying 166.87 percent, computed $387,904 as the audited total purchases for 2004. The Department increased the audited total purchases by $9,767 for a decrease in inventory in 2004, and reduced it by $1,440 for self-consumption and $3,963 for pilferage, to compute adjusted COGS of $392,268. The Department applied the 92.14 percent taxable merchandise purchase ratio to establish audited taxable COGS of $361,436 for 2004. The Department added the 40.65 percent weighted average taxable markup to the audited taxable COGS to establish audited taxable sales of $508,360 for 2004. The Department compared this amount to petitioner's correct reported taxable sales of $218,446 to compute an understatement of $289,914, which is an understatement of 132.7165 percent. The Department applied the 132.7165 percent rate of understatement to the $843,259 reported taxable sales for the audit period to established understated taxable sales of $1,119,143.

Although the reaudit resulted in understated taxable sales of $1,119,143, the Department did not timely assert an increase to the $698,150 determined understatement. (See Rev. & Tax. Code, § 6563.) Accordingly, petitioner's liability for the audit period is limited to the determined understatement of $698,150. Petitioner disputes this deficiency, contending that he included lottery ticket purchases in the COGS he reported on his FITR's, and that his weighted average taxable markup was around 25 percent rather than the 40.65 percent that the Department used in its audit computations.

We note that petitioner never provided complete purchase records to confirm the accuracy of the COGS reported on his FITR's, or to support the allegation that he included purchases of lottery tickets in those COGS. Instead, petitioner's assertion that the $338,566 COGS he reported on his 2004 FITR includes $215,497 in lottery ticket purchases, for net merchandise purchases of $123,069, is contradicted by the Department's analysis of petitioner's 2004 purchases, which was based on the best available evidence, the vendor survey responses. The Department's computations resulted in audited merchandise purchases of $387,904, which supports a finding that petitioner not only did not include lottery purchases in his reported COGS for 2004, but also underreported those COGS. Petitioner has not provided any evidence showing that the Department's audit methodology of using petitioner's documented purchases to extrapolate audited purchases for 2004 led to an inaccurate compilation of his purchases for 2004, or even alleged that such was the case (except for the implied allegation of error based on his argument that his FITR COGS included lottery ticket purchases). Petitioner has not disputed the responses to the vendor survey from the four vendors, has not argued that the self-consumption or pilferage allowances are inadequate, and has not identified any significant errors in the purchase segregation test. We conclude that the taxable purchases established in the reaudit accurately reflects petitioner's taxable purchases.

In our review of the reaudit, we did discover a calculation error in the purchase segregation test which, as explained in the D&R, reduces the taxable merchandise purchase ratio from 92.14 to 90.95 percent, and reduces the unreported taxable sales from $1,119,143 to $1,085,780. Since this understatement is still well above the determined liability which is the limit of petitioner's liability, we did not recommend a reaudit to correct the error.

Petitioner has provided no evidence in support of his general allegation that a 25 percent weighted average taxable markup is more accurate than the 40.65 percent weighted average taxable markup computed by the Department. We reject petitioner's unsupported assertion. (We calculate that applying this markup to the taxable cost of goods using the correct taxable purchase ratio produces an understatement of taxable sales that remains approximately $180,000 more than the determined understatement.) We find that petitioner has not established that a reduction to the determined liability is warranted.

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

The Department imposed the negligence penalty because it considered petitioner's books and records inadequate for sales and use tax reporting purposes, and it was required to use indirect methods to establish petitioner's taxable sales, leading to a substantial audited understatement in taxable sales. Petitioner contends that he accurately recorded his daily gross receipts which he properly reported.

We find that petitioner's reported taxable sales are not supported by his records. We note that both the audited taxable COGS based on the COGS reported on petitioner's FITR's and the audited taxable COGS based on vendor survey documentation significantly exceeds petitioner's reported taxable sales. Petitioner failed to provide summary records for both purchases and sales, and has not provided detailed purchase records to support his reported amounts. We conclude that this deficiency in maintaining purchase and sales records represents negligence in recordkeeping.

Issue 3: Whether petitioner has established reasonable cause to be relieved of the amnesty double negligence and amnesty interest penalties. We conclude that he has not.

Since petitioner did not participate in the amnesty program, an amnesty double negligence penalty of $471.36 was imposed in the Notice of Determination, and an amnesty interest penalty of $400.64 will be imposed when this liability is final. We sent petitioner a letter explaining these penalties and how he could request relief of the penalties. Petitioner has not submitted any request for such relief. Accordingly, we have no basis upon which to consider recommending relief of the amnesty penalties.

OTHER DEVELOPMENTS

After the D&R was issued, the Department prepared a second reaudit to delete the deficiency measure increases proposed by the first reaudit. The Department then discovered that the signed waiver of limitation for 1Q03 was missing from the audit work papers, and thus prepared a third reaudit to delete the measure of tax established for 1Q03. However, since the understatement for all other quarters still exceeds the determined liability, the third reaudit includes an adjustment offsetting the reduction for 1Q03 such that the measure of deficiency reflected in the third reaudit equals the determined measure of deficiency.

Summary prepared by Pete Lee, Business Taxes Specialist II

MARKUP TABLE

Percentage of taxable vs. nontaxable purchases	92.14% taxable
Mark-up percentages developed	40.65% weighted taxable markup
Self-consumption allowed in dollars	$1,440 per year
Self-consumption allowed as a percent of total purchases	0.38% of COGS
Pilferage allowed in dollars	$7,612 (2 years)
Pilferage allowed as a percent of total purchases	1% of COGS