

1 CALIFORNIA STATE BOARD OF EQUALIZATION

2 APPEALS DIVISION FINAL ACTION SUMMARY

3 In the Matter of the Petition for Redetermination)
 4 Under the Sales and Use Tax Law of:)
 5 GWANG H. SONG & KEUM J. SONG, dba) Account Number: SR AP 97-704261
 6 Alta Dena Drive In Dairy) Case ID 433708
 7 Petitioner) Glendora, Los Angeles County

8 Type of Business: Drive-in Dairy

9 Audit period: 07/01/03 – 06/30/06

10 Item Disputed Amount

11 Unreported sales \$538,315¹
 12 Cigarette rebates \$96,666
 13 Negligence penalty \$5,239

	<u>Tax</u>	<u>Penalty</u>
14 As determined and protested:	<u>\$52,386.02</u>	<u>\$5,238.62</u>
15 Proposed tax redetermination	\$52,386.02	
16 Interest through 2/28/11	27,518.67	
17 Negligence penalty	<u>5,238.62</u>	
18 Total tax, interest, and penalty	<u>\$85,143.31</u>	
19 Monthly interest beginning 3/1/11	<u>\$305.59</u>	

19 The Board held a hearing regarding this matter on October 20, 2010, granting petitioners 30
 20 days to provide additional records to support its assertion that it made sales of cigarettes for resale to a
 21 relative and granting the Sales and Use Tax Department (Department) 30 days to respond. After the
 22 hearing, petitioner informed the Department that neither petitioner nor the relative have any additional
 23 records to provide. Accordingly, our analysis and recommendation remain the same.

24 **UNRESOLVED ISSUES**

25 **Issue 1:** Whether adjustments are warranted to the amount of unreported sales. We
 26 recommend no adjustment.

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 28 ¹ Petitioner protests an unspecified portion of this amount.

1 Petitioner has operated a drive-in dairy, selling grocery items, beer, wine, cigarettes, and
2 miscellaneous taxable merchandise, since May 2000. In its preliminary review, the Sales and Use Tax
3 Department (Department) computed book markups of 31 percent for 2004 and 40 percent for 2005,
4 which appeared reasonable for this type of business. However, upon further examination, the
5 Department found that recorded purchases of taxable merchandise were significantly understated. The
6 Department obtained information from some of petitioner's vendors, which it used to compile
7 purchases of taxable merchandise of \$259,470 for the period July 1, 2004, through June 30, 2005
8 (purchases of taxable merchandise from Sam's Club alone was \$181,551, which substantially exceeded
9 recorded purchases of taxable merchandise of \$117,727). For the remaining vendors, who did not
10 provide transaction information, the Department used available purchase invoices to estimate
11 purchases of \$21,974, for a total amount of taxable purchases of \$281,444 (\$259,470 + \$21,974) for
12 the period July 1, 2004, through June 30, 2005. The Department reduced that amount by 1 percent for
13 pilferage to compute the audited cost of taxable goods sold.² The Department used shelf tests to
14 compute a weighted average markup of 19.84 percent.³ The Department used the audited markup and
15 the audited cost of taxable goods sold to compute audited taxable sales of \$333,910 for the 12-month
16 test period, which exceeded reported taxable sales of \$160,808 for the same period by 107.64 percent.
17 The Department applied that percentage of error to reported taxable sales for the audit period to
18 establish unreported sales of \$538,315.

19 Petitioner contends that the audited markup of 13.21 percent for cigarettes and tobacco
20 products is excessive. Petitioner states that its sales of cartons are greater than the 10 percent of total
21 cigarette sales estimated by the Department. Since the markup for sales of cartons is lower than the
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24 ² The Department did not make an adjustment for self-consumed merchandise. According to the audit comments, petitioner
25 stated there was minimal self-consumption of ex-tax inventory. Also, the Department's review of purchase reports from
26 Sam's Club disclosed that petitioner made ex-tax purchases, under a resale certificate, of items for personal use (in addition
27 to the merchandise purchased for inventory). The cost of those purchases was also minimal, and the Department did not
28 establish an understatement for the cost of goods purchased for personal use for which petitioner erroneously provided a
resale certificate. We find that any allowance in the audit for self consumption would be offset by the tax petitioner owes
on the cost of its purchases known at the time of purchase as for personal consumption which were incorrectly made under
a resale certificate.

³ The markups for individual product categories were 28.24 percent for beer and wine, 41.91 percent for soda,
13.21 percent for cigarettes and tobacco products, 21.28 percent for newspapers and magazines, and 24.78 percent for
miscellaneous taxable merchandise.

1 markup for sales of packs, petitioner asserts that the overall markup for cigarettes should be reduced.
2 However, petitioner has provided no documentation, such as cash register tapes, to support its assertion
3 that sales of cartons of cigarettes account for more than 10 percent of the cigarettes sold.

4 In the absence of documentation to support a higher percentage of cartons to total cigarettes
5 sold, we recommend no adjustment. In addition, we find that the weighted average audited markup of
6 19.84 percent is lower than we would expect in a business of this type.⁴ Accordingly, we find there is
7 no basis to recommend a reduction in the audited markup. Further, we have reviewed the audit
8 workpapers and have found no inaccuracies in the audit procedures and computations that warrant
9 adjustment of the audit results.

10 We note that petitioner pleaded with us at the conference to reduce the tax liability because,
11 due to the bad economy, it has no funds to pay the amount due. While we empathize with petitioner's
12 financial difficulties, we note that inability to pay is not a basis for reducing the tax liability. We
13 explained to petitioner that it may request that the Department establish an installment payment plan.

14 **Issue 2:** Whether the measure of tax for rebates received from cigarette manufacturers should
15 be deleted because petitioner did not collect sales tax reimbursement with respect to those amounts.
16 We recommend no adjustment.

17 The Department found that petitioner had received rebates from cigarette manufacturers. Since
18 the rebates were based on the number of cigarettes sold by petitioner, and petitioner was required to
19 reduce its selling price of cigarettes by an amount equal to the rebate, the Department concluded that
20 the rebates represented gross receipts from taxable sales. The Department used federal forms 1099 to
21 compile rebates from cigarette manufacturers of \$96,666.

22 Petitioner concedes that the rebates at issue are subject to tax. However, petitioner states that it
23 did not collect sales tax reimbursement from its customers on the amounts of the cigarette rebates
24 because it was not aware at the time that the rebates were subject to tax. Petitioner asks that the
25 measure of tax for rebates from cigarette manufacturers be deleted because it did not collect the sales
26 tax reimbursement.

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28 ⁴ We generally expect the markup for taxable sales to be at least 25 percent for a business of this type.

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MARKUP TABLE

Percentage of taxable vs. nontaxable purchases	Unknown*
Mark-up percentage developed	19.84%
Self-consumption allowed in dollars	None
Pilferage allowed in dollars for the 12-month test period	\$2,825
Pilferage allowed as a percent of total purchases	1%

* The Department did not compute an audited amount of total purchases.