

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 STORE2DOOR, INC.)

6 Petitioner)

Account Number: SR Y AC 100-049715

Case ID 352179

Burbank, Los Angeles County

7 Type of Business: Two convenience stores

8 Audit period: 01/01/03 – 12/31/05

9 Item Disputed Amount

10 Unreported sales, Burbank store \$915,103

Purchases of fixed assets subject to use tax \$ 999

11 Unreported cigarette rebates \$ 18,246

12 Negligence penalty \$ 7,708

Tax

Penalty

13 As determined: \$90,695.82 \$9,069.62

14 Pre-D&R adjustment 11,718.15 1,171.76

15 Post-D&R adjustment -21,298.60 -2,129.82

Post-Board hearing adjustment - 4,031.60 - 403.17

16 Proposed redetermination, protested \$77,083.77 \$7,708.39

17 Proposed tax redetermination \$ 77,083.77

Interest through 08/31/13 54,941.81

18 Negligence penalty 7,708.39

19 Total tax, interest, and penalty \$139,733.97

Payments - 406.26

20 Balance Due \$139,327.71

21 Monthly interest beginning 09/01/13 \$ 383.39

22 The Board held a hearing regarding this matter on October 21, 2010. The Board granted
23 petitioner time to present additional records and directed the Sales and Use Tax Department
24 (Department) to conduct a reaudit if warranted based on the material presented. Based on the findings
25 of a post-Board hearing reaudit, we recommend a reduction in the understatement of reported taxable
26 measure of \$48,868, as explained under Post Hearing Developments.

STATE BOARD OF EQUALIZATION
SALES AND USE TAX APPEAL

UNRESOLVED ISSUES

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2 **Issue 1:** Whether adjustments are warranted to the amounts of unreported sales. We
3 recommend no further adjustment other than those explained under Post Hearing Developments.

4 Petitioner operates two convenience stores, one in Burbank, which was open for the entire audit
5 period, and one in Van Nuys, which opened on June 14, 2005. A substantial percentage of the
6 merchandise sold is delivered by petitioner to its customers. The Burbank store also made taxable
7 sales of hot food products, and it made sales to the corporate officers at cost. In its preliminary review,
8 the Sales and Use Tax Department (Department) computed negative markups (that is, sales below cost)
9 for each year of the audit period using petitioner's recorded costs and reported sales. The Department
10 considered the negative markups to be evidence that reported taxable sales were understated and
11 decided to establish audited taxable sales on a markup basis.

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

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

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

15 Petitioner raises several issues regarding the computed amounts of taxable sales. Petitioner
16 argues that the audited amounts of taxable delivery charges are excessive. The audited ratio of
17 delivery charges to total sales was based on a review of cash register tapes dated after the audit period,
18 which were the only cash register tapes petitioner provided during the audit. Petitioner asserts that for
19 the Burbank store, the delivery charge was lower during the audit period than it was after the audit
20 period. For the Van Nuys store, petitioner asserts that the store did not begin making deliveries until
21 2006, after the audit period. In the D&R, we recommended that, as part of the reaudit, the Department
22 review additional documentation to be provided by petitioner with respect to the delivery charges.
23 During that reaudit, petitioner provided cash register tapes for three days, March 31, 2003, May 18,
24 2004, and September 1, 2005. However, the cash register tapes did not provide evidence to support
25 petitioner's contention because they did not show information regarding the delivery charges.

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

1 Nevertheless, the Department made an adjustment to reflect a reduction in the delivery charge from the
2 \$3.99 used in the audit to the \$2.99 stated by petitioner as the delivery charge for the Burbank store
3 during the audit period. Since petitioner did not provide evidence that there were no delivery sales for
4 the Van Nuys store in 2005, the Department did not delete the audited delivery charges for that store,
5 but it did make the same adjustment made for the Burbank store, reducing the audited delivery charge
6 from \$3.99 to \$2.99.

7 Petitioner also contends that the audited percentage of delivery sales should be reduced for the
8 Burbank store and that the additional measure for delivered sales should be eliminated for the Van
9 Nuys store based on its contention that deliveries were not made by the Van Nuys store during the
10 audit period. During the reaudit, petitioner did not provide convincing evidence to support lower
11 percentages of delivery sales (as noted above, the cash register tapes provided by petitioner did not
12 show information regarding the delivery charges). Consequently, the Department made no adjustment
13 to the audited percentage of delivery sales for either store.

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

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

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

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

7 During the audit, the Department scheduled purchases of fixed assets from petitioner's general
8 ledger. Since petitioner did not provide purchase invoices to show that it had paid tax to the Board or
9 tax reimbursement to its vendors with respect to those purchases, the Department concluded that all the
10 purchases were subject to use tax. Based on documentation provided during the reaudit, the
11 Department has reduced the purchases of fixed assets subject to use tax from \$9,799 to \$999.
12 Petitioner's records do not include a vendor name for either of the remaining purchases so that the
13 Department could determine if either vendor was a California retailer, and petitioner has not otherwise
14 shown that the purchases were subject to sales tax or that it paid use tax with respect to the two
15 remaining purchases. Thus, we find no further adjustments are warranted.

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

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

22 The contracts in this case represent a three-party arrangement, in which petitioner has
23 purchased the cigarettes from a vendor, but received the rebate from the manufacturer, the third party.

24 _____
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.

1 The audit workpapers include copies of two contracts between petitioner and RJ Reynolds, which
2 show that, as a condition of receiving the rebates, petitioner was required to reduce the retail selling
3 prices of the cigarettes by an equivalent amount. Thus, the rebates represent taxable gross receipts.

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

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

9 Since we have concluded there is a substantial understatement, we reject petitioner's assertion
10 that most of the determined tax is not due. We find that petitioner was negligent in recordkeeping
11 because it did not maintain source documents (complete cash register tapes) for the audit period. We
12 also find petitioner did not exercise due care in preparing returns. The understatement of reported
13 taxable sales in the most recent reaudit is \$915,103, which represents an error ratio of 86 percent when
14 compared to reported taxable sales for both stores of \$1,059,946. Petitioner has not provided a non-
15 negligent explanation for its failure to report almost half of its taxable sales. Further, we note that,
16 based on petitioner's books, the costs of taxable merchandise exceeded reported taxable sales for each
17 year of the audit period. We find that any businessperson should have recognized discrepancies of that
18 magnitude. For all these reasons, we find the understatement was the result of negligence, and the
19 penalty was properly applied, even though the business had not been audited previously.

20 **POST HEARING DEVELOPMENTS**

21 At the Board hearing, petitioner contended that numerous adjustments should be allowed and
22 stated that it could provide records to support adjustments. Subsequent to the hearing, petitioner
23 provided purchase invoices for 2003 through 2006 and an electronic download from its point of sale
24 cash register from the Burbank store. The Department used these records to expand the purchase
25 segregation test and to recalculate the percentages of delivery sales and store sales. The Department
26 also corrected an error noted in the audited markup for liquor. As a result, the audited understatement
27 of reported taxable sales for the Burbank store was reduced by \$47,851, from \$962,954 to \$915,103.
28 The Department also deleted the understatement of reported taxable sales of \$1,017 for the Van Nuys

1 store, since it concluded the amount was immaterial. We concur, and we recommend a reduction of
2 the understatement of reported taxable sales of \$48,868 (\$47,851 + \$1,017).

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

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.