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:	
YOHANNES KAHSAI, dba The Alameda Mini Market	Account Number: SR GH 97-121005 Case ID 426226
Petitioner	Santa Clara, Santa Clara County

Type of Business: Convenience store

Audit Period: 1/01/04 – 12/31/06

Items	Amounts in Dispute	
Unreported taxable sales	$154,444	
Negligence penalty	$ 1,274	
	Tax	Penalty
As determined and protested	$12,741.71	$1,274.19

Proposed tax redetermination	$12,741.71
Interest through 2/28/09	4,243.16
Penalty	1,274.19
Total tax, interest, and penalty	$18,259.06
Monthly interest beginning 3/1/09	$84.94

UNRESOLVED ISSUES

Issue 1: Whether the Sales and Use Tax Department (Department) has accurately computed petitioner's taxable sales. We conclude it has and that no adjustments are warranted.

During the audit, the Department performed a segregation test of petitioner's purchase invoices for the second quarter of 2005 and found that 79.83 percent of the purchases were for taxable merchandise. The Department initially applied the taxable ratio of 79.83 percent to the cost of goods sold as recorded on petitioner's federal income tax returns (FITR's) and found that the cost of taxable goods sold was substantially greater than reported taxable sales. Thus, the Department concluded that reported taxable sales were significantly understated. Accordingly, the Department decided to compute petitioner's taxable sales using the markup method.

The Department performed a shelf test using purchase invoices from March 2007 and selling prices posted on the shelf or provided orally by petitioner, and computed taxable markups of 29.11 percent for beer, 25.78 percent for soda, 21.76 percent for tobacco products, and 71.31 percent for miscellaneous taxable merchandise. In computing the markups for beer and soda, the Department excluded products that had markups exceeding 40 percent. In sum, the Department computed a weighted markup of 27.86 percent to establish taxable sales. However, rather than use the taxable merchandise purchase ratio of 79.83 percent obtained from a purchase segregation test of the second quarter of 2005, in order to be conservative, the Department decided to compute audited taxable cost of goods sold using the results of the purchase segregation test from the prior audit,[1] which disclosed a taxable merchandise purchase ratio of 73.04 percent. The Department applied the weighted markup of 27.86 percent to audited cost of taxable goods sold (cost of goods sold as reported on FITR's minus 1 percent for pilferage[2]) and calculated that petitioner had underreported his taxable sales by $154,444.

Petitioner contends that an allowance of 2.4 percent should be made for theft, breakage, and spoilage, that the markup method should not be used to compute taxable sales and audited taxable sales should instead be based on cash register tapes, that his bank deposits support reported sales, and that the weighted markup of 27.86 percent is too high. We note that the audit already includes a 1-percent adjustment for theft. We recommend no additional adjustment for spoilage and breakage because, while nontaxable food products could have spoiled prior to being sold, we believe virtually all taxable merchandise would have been sold by petitioner prior to spoilage and that breakage of taxable merchandise would have been minor. Additionally, petitioner has provided no documentation to support his assertion that he discarded significant amounts of taxable merchandise due to spoilage and breakage.

We note that petitioner's daily sales reports appear to have been prepared by using cash register tapes, and that the sales reports support an understatement of taxable sales of at least $78,856. In this case, the audited cost of taxable merchandise greatly exceeds reported taxable sales. In light of this

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[1] The first six months of 2000 were used as a test period for the purchase segregation test in the prior audit for the period July 1, 1998, to September 30, 2000.

strong evidence that reported taxable sales are understated, we conclude that reported taxable sales are understated, even if reported amounts agree with the amounts recorded on cash register tapes. The bank deposits also do not support reported sales. Petitioner's bank deposits of $82,307 for year 2004 were substantially less than reported taxable sales of $203,463 for the same year. We expect that most of petitioner's customers paid for merchandise with cash, and it is clear that most of the cash that petitioner received from customers was not deposited into the business bank account.

Petitioner argues that the markup for soda should be about 20 percent (not 25.78 percent), and that the markup for miscellaneous taxable merchandise should be about 30 to 35 percent (not 71.31 percent). Petitioner has provided no documentation to support this contention. Petitioner notes that the weighted markup was only 19.12 percent in the prior audit. We find that petitioner's markup increased since the prior audit. However, neither petitioner nor the Department has provided documentation to establish precisely when the markup increased. The Department initially computed a weighted markup of 35.86 percent, but reduced it to 27.86 percent to exclude costs and selling prices for beer and soda products that had markups in excess of 40 percent. Additionally, the Department used the prior audit taxable merchandise purchase ratio of 73.04 percent, instead of the 79.83 percent as calculated in the purchase segregation test for the second quarter of 2005. Accordingly, we find that the reduction of the markup and the use of the lower taxable merchandise purchase ratio fully account for the possibility that petitioner's markups may have been lower during the early part of the current audit period. Thus, we recommend no adjustment to the weighted markup of 27.86 percent.

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

The Department imposed the negligence penalty because petitioner underreported a large amount of taxable sales, and similar errors were found in the prior audit for the period July 1, 1998, to September 30, 2000. Petitioner opposes the penalty because he maintained a complete set of books and records and believes he was not negligent in reporting his taxes.

We note that the Department also used the markup method in the prior audit to compute petitioner's taxable sales and found that petitioner underreported 48.8 percent of his taxable sales

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[2] The audit work papers indicate that no allowance was made for self consumption because petitioner self consumed an

during the prior audit period (an understatement of $84,930 compared to reported taxable sales of $174,065). In the current audit, the Department found that petitioner underreported 60.6 percent of his taxable sales (an understatement of $154,444 compared to reported sales of $254,779). It is clear that the errors in the current audit are the same types of errors that occurred in the prior audit. Also, the error ratio of 60.6 percent in the current audit is significantly greater than the prior audit error ratio of 48.8 percent, which indicates that petitioner has not taken any action to improve the accuracy of his reporting. Additionally, the taxable sales recorded in petitioner's daily sales reports exceed reported taxable sales by $78,856 or 31 percent. We would expect petitioner to have been able to accurately report all of the taxable sales recorded in his own records, especially when considering that he was previously audited. Finally, the audited taxable merchandise purchases significantly exceed reported taxable sales. For all these reasons, we find that petitioner was negligent in reporting.

OTHER DEVELOPMENTS

None.

Summary prepared by John K. Chan, Business Taxes Specialist I

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immaterial amount.

MARKUP TABLE

Percentage of taxable vs. nontaxable purchases	73.04%
Mark-up percentage developed	27.86%
Self-consumption allowed in dollars	None
Self-consumption allowed as a percent of total purchases	None
Pilferage allowed in dollars	$2,703 for 2004 & 2005
Pilferage allowed as a percent of cost of goods sold	1%