

## 1 CALIFORNIA STATE BOARD OF EQUALIZATION

## 2 APPEALS DIVISION SUMMARY FOR BOARD HEARING

3 In the Matter of the Petitions for Redetermination )  
 4 under the Sales and Use Tax Law of: )  
 5 KHURSHID ALAM KHAN, ) Account Number: SR AR 97-505627  
 6 dba Best Buy Cigarettes ) Case IDS 359066, 241965, 359065  
 7 Petitioner ) Palmdale, Los Angeles County

8 Type of Business: Cigarette stores

9 Audit Periods: 3/1/99 – 12/31/99 (Case ID 359066)

1/1/00 – 12/31/02 (Case ID 241965)

10 1/1/03 – 3/31/04 (Case ID 359065)

11 Items	12 Amounts in Dispute					
	359066		241965		359065	
13 Case ID						
13 Underreported taxable sales	\$586,268		\$2,527,256		\$953,212	
14 Fraud penalty	\$ 12,092		\$58,807		\$ 19,660	
14 Amnesty double-fraud penalty	\$ 12,092					
15 Amnesty interest penalty	\$ 12,643		\$34,981			
	359066		241965		359065	
	Tax	Penalty	Tax	Penalty	Tax	Penalty
17 As determined	\$48,367.13	\$24,183.60	\$29,043.43		\$78,640.02	\$19,660.05
18 Adjustment:						
Sales and Use Tax Department			+206,186.12	+58,807.43		
19 Proposed redetermination	\$48,367.13	\$24,183.60	\$235,229.55	\$58,807.43	\$78,640.02	\$19,660.05
Amount concurred in			-29,043.43			
20 Protested	<u>\$48,367.13</u>	<u>\$24,183.60</u>	<u>\$206,186.12</u>	<u>\$58,807.43</u>	<u>\$78,640.02</u>	<u>\$19,660.05</u>
Proposed tax redetermination	\$48,367.13		\$235,229.55		\$78,640.02	
21 Interest through 6/30/09	44,996.41		165,817.87		40,478.71	
Fraud penalty	12,091.80		58,807.43		19,660.05	
22 Amnesty double fraud penalty	12,091.80					
Amnesty interest penalty	<u>12,643.33</u>		<u>34,980.88</u>			
23 Total tax, interest, and penalties	<u>\$130,190.47</u>		<u>\$494,835.73</u>		<u>\$138,778.78</u>	
24 Monthly interest beginning 7/1/09	<u>\$322.45</u>		<u>\$1,568.20</u>		<u>\$524.27</u>	

## 25 UNRESOLVED ISSUES

26 **Issue 1:** Whether petitioner has established that amounts recorded in sales journals were not  
 27 additional taxable sales of cigarettes. We conclude that no adjustment is warranted.

28 Petitioner, a sole proprietor doing business as Best Buy Cigarettes, operated two cigarette

1 stores in Palmdale, California that sold cigarettes and a few small food items. The store located at  
2 2315 East Palmdale Boulevard (location 1) started business on March 1, 1999, and operated  
3 throughout the audit periods. The store located at 248 East Palmdale Boulevard (location 2) began on  
4 June 1, 2001, and operated throughout the audit period until both stores were sold and petitioner's  
5 seller's permit closed out as of August 31, 2006.

6 Petitioner reported sales and use tax on a total sales basis (net of cigarette shelf allowances and  
7 rebates) and claimed deductions for sales tax reimbursement. For the three audit periods at issue,  
8 Mr. Jeff Lentz, petitioner's accountant and bookkeeper, stated that he picked up a packet from  
9 petitioner every month that contained sales amounts and related bank deposits. Based on this  
10 information provided by petitioner, Mr. Lentz prepared petitioner's sales and use tax returns. The  
11 Sales and Use Tax Department (Department) performed a routine audit of petitioner books and records  
12 for the period of January 1, 2000, through December 31, 2002, establishing unreported taxable  
13 cigarette rebates along with a small allowance for unclaimed exempt food sales. A Notice of  
14 Determination (NOD) was thereafter issued on September 18, 2003, and petitioner filed a timely  
15 petition for redetermination (Case ID 241965). Petitioner does not protest this particular item.

16 On April 7, 2004, the Board's Investigation Division (ID) assisted the Los Angeles Sheriff's  
17 Department in an inspection of petitioner's two business locations, where the Sheriff's Department  
18 seized cigarettes, cash, and business records. The seized cigarettes consisted of a total of 600 cartons  
19 of counterfeit stamped GT One brand and Roger brand cigarettes: 450 cartons at location 1, and 150  
20 cartons at location 2. The seized business records consisted of hand-posted sales journals (which were  
21 different than the records provided during the initial audit), for location 1 for the period March 1, 1999,  
22 to April 6, 2004 (the entire audit period at issue), and for location 2 for the period February 1, 2003, to  
23 April 4, 2004. No journals were found for location 2 for the period June 1, 2001 (the date location 2  
24 opened), to January 31, 2003. The journals contained a detailed record of each location's daily sales,  
25 which included dates, "buy downs," number of customers, credit cigar sales, total sales, and a column  
26 described as "Jeff." ID found that the "Jeff" column represented the amounts petitioner provided to  
27 Mr. Lentz for sales and use tax reporting purposes. ID also found that the "Total" column of the  
28 journals were significantly higher than those listed in the "Jeff" column. Based on the 600 cartons of

1 counterfeit stamped cigarettes seized during the search, the ID determined that petitioner was selling  
2 large quantities of illegal cigarettes and not reporting those sales on his sales and use tax returns.

3         Based on the sales represented by the hand-posted journals, the Department established that  
4 petitioner underreported taxable sales by \$586,268 for the period March 1, 1999, to December 31,  
5 1999, and by \$953,212 for the period January 1, 2003, to March 31, 2004, and NODs were issued on  
6 June 22, 2006. The Department also prepared a reaudit dated March 15, 2006, for the audit period  
7 January 1, 2000, to December 31, 2002 (case ID 241965), which increased the unreported taxable sales  
8 by \$2,527,256 and imposed a fraud penalty. A letter dated August 24, 2006, was sent to petitioner  
9 asserting the increase pursuant to Revenue and Taxation Code section 6563.

10         Petitioner contends that the hand-posted sales journals do not reflect actual sales amounts for  
11 locations 1 and 2. Petitioner concedes that he sold illegal cigarettes, but claims the reported amounts  
12 in the “Jeff” column include sales of both legal and illegal cigarettes that were correctly reported to the  
13 Board. As to the difference between the “Total” and “Jeff” columns, petitioner contends that he was a  
14 partner with Mr. Imad Moghrabi in another unrelated business, Cig Store #2 at 1040 East Avenue J,  
15 suite D-10, in Lancaster, California, which also sold cigarettes. Petitioner argued that the hand-posted  
16 journals included sales amounts from this other business in the “Total” column. Petitioner claims that  
17 Cig Store #2 was registered with the Board and had a seller’s permit (SR AR 99-458507). Petitioner  
18 notes that Cig Store #2 was sold and closed in 2004. Petitioner alleges that his partner, Mr. Moghrabi,  
19 kept the partnership records and filed sales and use tax returns for Cig Store #2. Petitioner claims that  
20 the sales journals for locations 1 and 2 both contained tax-included sales amounts for the Cig Store #2  
21 so petitioner could determine how that business was doing.

22         The Sales and Use Tax Law requires every retailer to keep and maintain adequate and complete  
23 business books and records, including receipts and invoices evidencing purchases and sales, as well as  
24 the normal books of account ordinarily maintained by the average prudent businessman, so the Board  
25 may make a proper and accurate determination of taxes due. (Rev. & Tax. Code, §§ 7053, 7054; Cal.  
26 Code Regs., tit. 18, § 1698, subd. (b).) Where the Board is not satisfied with the return or returns of  
27 the tax or the amount of tax, or other amounts required to be paid by any person, it may compute and  
28 determine the amount required to be paid upon the basis of any information within its possession or

1 that may come into its possession. (Rev. & Tax. Code, § 6481.) Where the Board establishes a  
2 deficiency through the use of recognized and standard accounting procedures, the burden is upon the  
3 taxpayer to explain the disparity between the books and records and the results of the Board's audit.  
4 (*Riley B's, Inc. v. State Board of Equalization* (1976) 61 Cal.App.3d 610, 615-16.)

5 Here, the records provided to the Department during the original audit supported amounts  
6 reported to the Board. However, the seized hand-posted records disclosed that petitioner provided Mr.  
7 Lentz with taxable sales that represented less than the actual taxable sales made. The Department  
8 concluded, and we agree, that the hand-posted total taxable sales represent the actual taxable sales that  
9 should have been reported, particularly since petitioner was found to have been selling cigarettes with  
10 counterfeit stamps. We conclude that the difference between the amounts reported to the Board and  
11 the total amounts shown on the hand-posted journals represent unreported taxable sales of counterfeit  
12 stamped cigarettes.

13 Petitioner kept a separate journal containing detailed daily listings for each location. There is  
14 nothing in the journals to indicate the inclusion of additional sales from alleged partnership with  
15 Mr. Moghrabi at Cig Store #2. Additionally, Board records show, contrary to petitioner's contention,  
16 that the seller's permit for Cig Store #2 is for a sole proprietor and not a partnership, nor has petitioner  
17 provided any evidence to support his contention that the journals included sales from Cig Store #2.  
18 Given the detailed records petitioner kept for sales from his two locations, we find it inconsistent that  
19 petitioner cannot provide similar detail for the alleged sales from Cig Store #2. Also, petitioner has not  
20 provided any explanation for keeping two sets of books: the records he originally provided to the  
21 Department, and the hand-posted journals discovered in the consent search. Based on the foregoing,  
22 we find that petitioner's explanation for the additional sales posted in the journals lacks credibility, and  
23 that the Department used the best evidence available to determine petitioner's unreported taxable sales.  
24 We recommend no adjustments for this audit item.

25 **Issue 2:** Whether there is clear and convincing evidence of fraud or intent to evade the tax.  
26 We conclude that there was fraud or intent to evade the tax and that imposition of the fraud penalty is  
27 warranted.  
28

1 Section 6485 provides for the addition of a 25-percent penalty if any part of a deficiency  
2 determination was due to fraud or intent to evade the law or authorized rules or regulations. The  
3 Department must establish fraud by clear and convincing evidence. (Cal. Code Regs., tit. 18, § 1703,  
4 subd. (c)(3)(C).) While fraud or intent to evade tax cannot be presumed, direct evidence of fraud is  
5 rare and therefore circumstantial evidence that infers fraudulent intent is acceptable in sustaining the  
6 fraud penalty when based on a totality of the circumstances. (See *Tenzer v. Superscope, Inc.* (1985) 39  
7 Cal.3d 18, 30.) Circumstantial evidence indicative of fraud includes, among other things, the  
8 understatement of income, inadequate records, implausible or inconsistent explanations of behavior,  
9 concealment of assets, and failure to cooperate with tax authorities. (*Bradford v. Commissioner of*  
10 *Internal Revenue* (9<sup>th</sup> Cir. 1986) 796 F.2d 303, 307-08.) The Board's Audit Manual section 0507.25  
11 provides that evidence of a deliberate attempt to evade payment of tax includes, among other things,  
12 falsified records (especially when more than one set is kept), substantial discrepancies between  
13 recorded amounts and reported amounts which cannot be explained, and tax reimbursement properly  
14 charged but not reported.

15 Here, petitioner purchased and sold illegal counterfeit stamped cigarettes during the audit  
16 period, but did not report such sales. Petitioner tried to conceal these sales by maintaining two sets of  
17 sales journals for his business locations. Petitioner contends that the second set of books was used by  
18 him to track sales from a separate business, Cig Store #2. However, the detailed sales journals contain  
19 no entries that appear to be from any location other than the locations for which the sales journals were  
20 prepared. Petitioner has provided no evidence to support this explanation, and we find petitioner's  
21 explanation for his second set of books lacks credibility. We note that these second journals contained  
22 detailed daily sales information for each location, and included a column which we have found  
23 represents the amount of sales petitioner chose to report to the Board, and a second, higher amount,  
24 that reflected actual total sales for each location. We find that the only credible explanation for the  
25 second set of hand-posted records maintained by petitioner for the stores is that petitioner intended to  
26 evade the tax by understating reported taxable sales for his business.

27 Additionally, the audit revealed \$4,066,736 in unreported taxable sales, which represents an  
28 understatement of 147 percent when compared to petitioner's reported taxable measure of \$2,750,463

1 (\$4,066,736 ÷ \$2,750,463). This significant understatement is additional evidence of fraud which  
2 shows that petitioner willfully failed to report the full amount of taxable sales and pay the full amount  
3 of the tax to the Board for the audit period. Furthermore, petitioner has admitted to purchasing the  
4 illegal cigarettes with cash, and selling those illegal cigarettes through his locations. We find that this  
5 illegal activity is further evidence of intent to evade the sales tax. In addition, petitioner failed to  
6 cooperate with the Department during the audit examination, refusing to explain the large difference  
7 between the “Total” and the “Jeff” columns, and refusing to answer any of the Department’s questions  
8 (see exhibit 1 of the D&R). This failure to cooperate is also evidence of fraud.

9 Based on the foregoing we conclude that there is clear and convincing evidence that  
10 petitioner’s substantial understated tax liability is based on fraud or intent to evade the tax. Therefore,  
11 we find the fraud penalty was properly imposed.

#### 12 AMNESTY

13 An amnesty interest penalty totaling \$47,624.21 will apply when the liabilities are final because  
14 petitioner did not participate in the amnesty program. Additionally, an amnesty double fraud penalty  
15 of \$12,091.80 was imposed for the period March 1, 1999, through December 31, 1999.

16 In a statement dated August 19, 2008, signed under penalty of perjury by  
17 Mr. Edward G. Wong, petitioner’s attorney, Mr. Wong states that petitioner reported all taxable sales  
18 for his business during the audit periods. Therefore, Mr. Wong argues that the measure of tax  
19 computed by the Department is excessive and the fraud penalty and amnesty double-fraud penalty  
20 should be abated. He also states that the validity and accuracy of the audit findings were unknown  
21 prior to December 2006.

22 We conclude that petitioner’s arguments are without merit. The Department issued the first  
23 NOD on September 18, 2003. On January 10, 2005, the Department informed petitioner that the Board  
24 was offering an Amnesty Program from February 1, 2005, through March 31, 2005, and that the  
25 program applied to sales and use tax liability for reporting periods beginning before January 1, 2003.  
26 Therefore, petitioner was fully aware by the time the amnesty program commenced on  
27 February 1, 2005 (Rev. & Tax. Code, § 7071), of the terms of the amnesty program and that the  
28 Department had determined that he had underreported his taxes for amnesty-eligible periods. As for

1 the determinations issued on June 22, 2006, ID discovered the illegal cigarettes and hand-posted sales  
2 journals which contained detailed and accurate records of sales. These journals led to our conclusion  
3 that petitioner deliberately underreported and failed to disclose taxable sales in an attempt to evade the  
4 payment of tax. Given that petitioner was selling illegal cigarettes and keeping duplicate books which  
5 showed that he was intentionally underreporting his taxable sales, petitioner knew that he had  
6 additional tax liability beyond that contained in the first NOD for amnesty-eligible periods. Despite  
7 this knowledge, petitioner chose not to avail himself of the amnesty program. In order to avoid the  
8 amnesty penalties, petitioner could have and should have, entered into the amnesty program, even  
9 though the Department was still analyzing petitioner's records. Petitioner was selling illegal cigarettes  
10 and intentionally attempted to conceal unreported taxable sales. Therefore, petitioner's reason for  
11 failing to participate in the amnesty program (that he had reported all taxable sales for his business  
12 during the audit period) is baseless. Consequently, we conclude that petitioner's failure to participate  
13 in amnesty or satisfy his liabilities as required by the amnesty program was not due to reasonable cause  
14 and petitioner is not entitled to relief from the amnesty penalties.

15 However, pursuant to the Board's order at its meeting on March 18, 2008, we recommend that  
16 \$3,878.05 of the amnesty interest penalty for Case ID 241965, which is the portion related to cigarette  
17 rebates, be relieved provided that, within 30 days of the Notice of Redetermination, petitioner either  
18 pays the amnesty-eligible portion of the tax and interest related to cigarette rebates or enters into a  
19 qualifying installment agreement to do so and successfully completes that agreement.

20 **OTHER DEVELOPMENTS**

21 None.

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23  
24 Summary prepared by Rey Obligacion, Business Taxes Specialist III  
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**EVIDENCE OF FRAUD RELIED ON BY DEPARTMENT**

1.	Substantial deficiency, which cannot be explained as due to negligence or honest mistake.	Yes
2.	More than one set of records.	Yes
3.	Falsified records.	Yes
4.	Substantial discrepancies between recorded and reported amounts for which there is no valid explanation.	Yes
5.	Permit or license held by taxpayer throughout the audit period indicating that taxpayer was knowledgeable about the requirements of law.*	Yes
6.	Tax properly charged to customers, evidencing knowledge of the requirements of the law, but not reported.	Yes
7.	Transfers of amounts of unpaid tax from the tax accrual account to another income account.	No
8.	Consistent substantial underreporting.	Yes