

1 CALIFORNIA STATE BOARD OF EQUALIZATION

2 APPEALS DIVISION SUMMARY FOR BOARD HEARING

3 In the Matter of the Petition for Redetermination)
 4 Under the Sales and Use Tax Law of:)
 5 KRISHNA DEVI, ET AL.) Account Number: SR CH 97-921852
 6 dba Cigarettes 4 Less & Liquor) Case ID 341721
 7 Petitioner) Antioch, Contra Costa County

8 Type of Business: Retailer of cigarettes and tobacco products

9 Audit Period: 1/01/02 – 12/31/04

10 Item Amount in Dispute

11 Unreported cigarette rebates \$132,497¹
 12 Unreported sales \$607,474
 13 Negligence penalty \$6,077
 14 Amnesty penalties \$2,649

	<u>Tax</u>	<u>Penalties</u>
14 As determined	\$60,774.64	\$7,903.96
15 Add concurred in credit	<u>273.07</u>	
16 Protested	<u>\$61,047.71</u>	<u>\$7,903.96</u>
17 Proposed tax redetermination	\$60,774.64	
18 Interest through 7/31/09	29,935.15	
Negligence penalty	6,077.47	
19 Amnesty double negligence penalty	1,826.49	
Amnesty interest penalty	<u>822.45</u>	
Total tax, interest, and penalties	\$99,436.20	
20 Payments	<u>-5,565.26</u>	
Balance due	<u>\$93,870.94</u>	

21 Monthly interest beginning 8/1/09 \$368.06

22 UNRESOLVED ISSUES

23 **Issue 1:** Whether the audited amount of rebates received from cigarette manufacturers is
 24 excessive. We recommend no adjustments.

25 During the audit, the Sales and Use Tax Department (Department) found that petitioner
 26 received rebates from cigarette manufacturers consisting of cigarette rebates and shelf display income.

27 _____
 28 ¹ Petitioner disputes an unspecified portion of this amount.

1 The Department allowed \$120 per month starting in September 2002, to account for nontaxable shelf
2 display income, to compute taxable cigarette rebates of \$132,497.

3 Petitioner agrees that the cigarette rebates are taxable, but argues that the allowance for
4 nontaxable shelf display income should be greater. At the appeals conference, the Department
5 indicated that the allowance of \$120 per month for nontaxable shelf display income was based on
6 petitioner's oral statements. At the appeals conference, petitioner submitted copies of federal form
7 1099 which showed that it received \$1,480 in total rebates from the cigarette manufacturers for the
8 years 2003 and 2004. This amount is less than the amount allowed for nontaxable shelf display
9 income for the same years. Nevertheless, we recommended a reaudit so that this issue could be
10 reexamined. Upon reaudit, the Department could not make any adjustments for nontaxable shelf
11 display income because petitioner did not provide any documentation to support such adjustments.
12 Thus, we conclude that no adjustments are warranted.

13 **Issue 2:** Whether the audited amount of unreported taxable sales is excessive. We conclude
14 that no further adjustments are warranted.

15 During the audit, petitioner alleged that it reported taxable sales based on cash register tapes but
16 did not provide any cash register tapes for audit. The Department noted that gross receipts reported on
17 federal income tax returns (FITR's) reconciled with gross receipts reported on sales and use tax
18 returns. The Department also noted that achieved markups based on gross profit and cost reported on
19 FITR's were 7.5 percent for 2002, and 17.65 percent for both 2003 and 2004. However, the
20 Department noted that costs of goods sold reported on FITR's were not based on books and records but
21 appeared to be calculated to produce the desired achieved markup. Based on this concern, the
22 Department decided to examine cancelled checks and credit card payment information for 2003 and
23 2004. Petitioner did not provide complete cancelled checks for the year 2002.

24 Using 11 purchase invoices from H.F. Hillman issued during July, August, and September
25 2005, the Department computed that 97.86 percent of the merchandise purchased from Hillman was
26 taxable merchandise. The Department multiplied the amount of the cancelled check or credit card
27 payments to H.F. Hillman by 97.86 percent to compute the amount of purchases of taxable
28 merchandise made from Hillman. Also, using 7 purchase invoices from Pepsi issued during June, July,

1 August, and September 2005, the Department computed that 50.5 percent of the purchases from Pepsi
2 were taxable merchandise. The Department multiplied the amount of the cancelled check or credit
3 card payments to Pepsi by 50.5 percent to compute the amount of taxable merchandise purchases made
4 from Pepsi. Petitioner was able to provide all of the purchase invoices from Coca Cola for 2003 and
5 2004, and those purchase invoices were used by the Department to compute the amount of taxable
6 merchandise purchases made from that vendor. Based on these analyses, the Department established
7 taxable merchandise purchases of \$444,988 for 2003 and taxable merchandise purchases of \$426,084
8 for 2004. The taxable merchandise purchases of \$444,988 for 2003 is much greater than the \$250,379
9 of merchandise purchases and the \$294,593 of gross receipts reported on the 2003 FITR. The taxable
10 merchandise purchases of \$426,084 for 2004 is much greater than the \$269,679 of merchandise
11 purchases and the \$317,270 of gross receipts reported on the 2004 FITR. Thus, the Department
12 concluded that recorded merchandise purchases and reported taxable sales were grossly understated
13 and decided to establish taxable sales on a mark up basis.

14 Audited taxable merchandise purchases of \$444,988 for 2003 and \$426,084 for 2004 were
15 reduced by 3 percent for pilferage to compute audited cost of taxable goods sold of \$431,638 for 2003
16 and \$413,301 for 2004. No adjustment for self-consumption was made because petitioner stated that it
17 does not self-consume taxable merchandise. Using costs from purchase invoices from August and
18 September 2005 and selling prices posted on the shelf in September 2005 or provided orally by
19 petitioner, the Department computed shelf test markups of 11.99 percent for cigarettes and tobacco
20 products (based on 60 percent of cigarettes sold in packs and 40 percent in cartons) and 27.16 percent
21 for soda. These markups were weighted based on the ratio of products purchased in each category to
22 compute a weighted markup of 12.14 percent (cigarettes and tobacco products account for 99 percent
23 of petitioner's taxable sales).

24 The weighted markup of 12.14 percent was added to the audited costs of taxable goods sold to
25 compute audited taxable sales of \$484,039 for 2003 and \$463,476 for 2004. Upon comparison to
26 reported taxable sales (which were \$713,252 for the audit period), the following error ratios were
27 computed: 83.01 percent for 2003, 87.48 percent for 2004, and 85.17 percent for both years combined.
28 The error ratios of 83.01 percent and 87.48 percent were applied to reported taxable sales for their

1 respective years, and the 85.17 percent ratio was applied to reported taxable sales for 2002, to compute
2 unreported taxable sales of \$607,474 . As further support for this understatement, the Department
3 analyzed petitioner's bank deposits and computed an understatement of \$682,316.

4 Petitioner contends that, except for the cigarette rebates, taxable sales are not understated.
5 Petitioner contends that the error ratio of 85.17 percent should not have been applied to 2002 because
6 petitioner's markup in 2002 was much lower than it was in 2003 and 2004. Petitioner asserts that it
7 sold merchandise at slightly above cost in 2002 in order to build customer loyalty. However, petitioner
8 has not provided cash register tapes or purchase invoices from 2002. The only documentation that
9 petitioner presented for 2002 are copies of advertisements from 2002 for special promotional prices
10 that were in effect that year. The Department rejects the advertisements because they only identify
11 special promotional pricing, and do not identify petitioner's normal selling prices.

12 We note additionally that petitioner does not have purchase invoices from 2002 that could be
13 compared to selling prices. Thus, petitioner has no means of showing that its selling prices were only
14 slightly above cost in 2002.

15 Petitioner also contends that the audited amounts of taxable merchandise purchases from H.F.
16 Hillman and Pepsi are overstated. Thus, we recommended that a reaudit of the purchases from these
17 two vendors be made to give petitioner an opportunity to provide all of the purchase invoices from
18 H.F. Hillman and Pepsi for 2003 and 2004. The reaudit resulted in an increase in understated taxable
19 sales from \$607,474 to \$670,499. However, the statute of limitations prevented the Department from
20 asserting an increase in the tax pursuant to section 6563, and thus the measure of understated taxable
21 sales asserted by the Department remains at \$607,474.

22 **Issue 2:** Whether petitioner was negligent. We conclude that it was.

23 The Department imposed the negligence penalty because the understatement is large in relation
24 to the reported measure of tax and petitioner's records were incomplete. Petitioner opposes the penalty
25 because this was its first audit, petitioner is not sophisticated in matters of accounting, and English is a
26 second language for petitioner's partners (Ms. Devi did not speak English during the appeals
27 conference).

28 If the Department relied solely on the lack of books and records provided for audit, we would

1 give petitioner the benefit of doubt since this was petitioner's first audit and petitioner is not
2 sophisticated in matters of accounting. However, when added to petitioner's understatement of taxable
3 sales by 85.17 percent after having reported taxable sales in an amount less than its costs, we find that
4 petitioner was negligent and that the negligence penalty was appropriately applied.

5 AMNESTY

6 Although petitioner applied for amnesty, it did not enter into a qualifying installment payment
7 plan or pay the amnesty-eligible tax and interest by May 31, 2005. Thus, an amnesty doubled
8 negligence penalty of \$1,826.49 imposed pursuant to section 7073 subdivision (c), was included in the
9 Notice of Determination, and an amnesty interest penalty of \$1,240.93 will be imposed under section
10 7074, subdivision (a), when the liability becomes final.

11 Petitioner filed a request for relief of the amnesty penalties pursuant to section 6592 on the
12 basis that it did not understand the amnesty program and that it is appealing the audit results.
13 Petitioner explained that, at the time it filed for amnesty, it thought the amnesty penalties were only for
14 failure to maintain adequate records. Although petitioner submitted an application for amnesty, it did
15 not pay the liability or enter into an installment agreement because it intended to appeal the audit
16 results and did not want to have to pay the liability prior to completion of its appeal.

17 Although it appears that petitioner was confused about the amnesty program, its confusion does
18 not warrant relief of the amnesty penalties because petitioner acknowledges that, if it had understood
19 the amnesty program, it would *not* still not have fulfilled the requirements for amnesty (and would not
20 have applied for amnesty at all) because it intended to appeal the audit results and it did not want to
21 pay the audit liability.

22 Petitioner's hope to prevail in the appeals process and to avoid having to pay the liability is not
23 a basis for relief of the amnesty penalties, which are imposed for the very purpose of encouraging
24 payment of such amounts. We conclude that, petitioner's failure to pay the tax and interest applicable
25 to the amnesty eligible periods by May 31, 2005, or enter into a qualifying installment plan, was due to
26 petitioner's decision not to pay the audit liability, and not due to circumstances beyond petitioner's
27 control. However, as part of its order on March 18, 2008, the Board ordered that the amnesty interest
28 penalty be relieved with respect to tax on cigarette rebates, with the usual payment conditions. The

1 portion of the amnesty interest penalty imposed on such taxes is \$418.48. We therefore recommend
2 that \$418.48 of the amnesty interest penalty be relieved if, within 30 days of the Notice of
3 Redetermination, petitioner either pays in full the amnesty-eligible tax and interest due with respect to
4 rebates or enters into an installment payment agreement to do so within 13 months and successfully
5 completes that agreement.. We recommend that relief of the amnesty double negligence penalty and
6 \$822.45 of the amnesty interest penalty be denied.

7 **OTHER DEVELOPMENTS**

8 None.

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10 Summary prepared by Rey Obligacion, Business Taxes Specialist III.

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MARKUP TABLE

Percentage of taxable vs. nontaxable purchases	88.09%
Weighted mark-up percentage developed	12.14%
Self-consumption allowed in dollars	None
Self-consumption allowed as a percent of total purchases	None
Pilferage allowed in dollars	\$26,133 for 2003 and 2004 combined
Pilferage allowed as a percent of total purchases	3%

Mark up was based on a test of purchases established for the two year period 2003 and 2004. Petitioner did not provide purchase information for 2002.