STATE BOARD OF EQUALIZATION
SALES AND USE TAX APPEAL

CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION BOARD HEARING SUMMARY

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of:	
INTERFAB CORP., dba American Horse Products	Account Number: SR EA 24-686440 Case ID 488767
Petitioner	San Juan Capistrano, Orange County

Type of Business: Retailer of equestrian products and supplies

Audit period: 4/1/05 – 3/31/08

Item	Disputed Amount
Unreported sales	$1,324,773

Tax determined:	$105,261.17
Adjustment - Appeals Division	-244.83
Proposed redetermination	$105,016.34
Less concurred	2,346.39
Balance, protested	$102,669.95
Proposed tax redetermination	$105,016.34
Interest through 10/31/11	41,575.81
Total tax and interest	$146,592.15
Payments	2,000.00
Balance Due	$144,592.15
Monthly interest beginning 11/1/11	$515.08

UNRESOLVED ISSUE

Issue: Whether further adjustments to the audit computations are warranted. We conclude that no further adjustments are warranted.

Petitioner began operations in 1999 in a 1,750 square-foot warehouse in Laguna Niguel, and in July 2007, moved to a 7,700 square-foot retail store in a shopping plaza in San Juan Capistrano. The Sales and Use Tax Department (Department) noted that the gross receipts reported on petitioner's federal income tax return (FITR) for the 2005 fiscal year, ending May 31, 2006 (FY 2005), was $40,040 more than the total sales reported on sales and use tax returns, which petitioner could not explain. Further, the Department compared the gross receipts with the cost of goods sold (COGS) reported on that FITR and computed a book markup of 19 percent, but noted that the COGS reflected an inventory increase of over $140,000 during the year. The Department concluded that petitioner's inventory should not have increased significantly during that year, adjusted the COGS by deleting the beginning and ending inventories, and computed a book markup of only 1.1 percent. For the audit period, the Department compiled merchandise purchases from the general ledger and reduced the total by two percent for pilferage, $500 a month for donated inventory, and $53,000 for inventory loss due to fire[1] to compute total COGS of $2,965,780. The Department noted that comparing computed COGS of $2,965,780 with petitioner's reported taxable sales of $2,489,203 would result in a -16 percent markup. The Department concluded that petitioner's reported taxable sales were understated and decided to establish taxable sales on a markup basis.

The Department computed a 41.99 percent markup for periods after June 2007 based on a shelf test of two days' sales at the new location, and a 24.59 percent markup for periods prior to July 2007 based on a schedule provided by petitioner showing purchases by category and approximate markups for each category for sales made at the old location. At the appeals conference, the Department conceded that petitioner should be allowed an additional $396 per month adjustment to purchases for self consumption. The Department computed adjusted merchandise purchases of $2,953,620 for the audit period, and applied the audited markups to the merchandise purchases for their respective periods to compute audited sales before discounts of $3,828,976. Petitioner held an annual sale every May, and the Department allowed sales discounts of $5,000 for each year. The Department conducted a block test of claimed exempt sales in interstate commerce for the first quarter 2008 (1Q08), but none of the claimed transactions were verified as exempt, so the Department made no allowance for any of the $461,579 claimed exempt interstate commerce sales. The Department compared the $3,813,976 audited taxable sales with the $2,489,203 reported taxable measure and established a difference of $1,324,773.

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[1] Petitioner's president, James Carter, provided a newspaper article documenting a total loss of his 4,000 square foot ranch style home located in Modjeska Canyon by the Santiago Canyon wildfire on October 22, 2007. The $53,000 amount was based on petitioner's estimate and represents merchandise inventory stored at Mr. Carter's home at the time of the fire.

Petitioner contends that the audited COGS is overstated because: (1) the audit computations do not account for material increases in merchandise inventory during the audit period, (2) the $53,000 allowance for fire loss is insufficient, and (3) there should be an additional allowance for pilferage.

Petitioner contends that its inventory increased by over $550,000 during the audit period. After the appeals conference, petitioner provided FITR's for FY 2007 and FY 2008, reporting beginning and ending inventories of $1,228,085 and $602,682 for FY 2007 and $602,682 and $963,729 for FY 2008, respectively, which reflects a net decrease over those two years. More importantly, petitioner did not provide physical inventory counts or any other documentation to support the inventory amounts reported on the FITR's. The QuickBooks report that petitioner provided to support the $602,682 ending inventory of the FY 2007 FITR actually supports an inventory of $331,168, which is $271,514 less. Petitioner alleges that the inventory decline in FY 2007 includes an $868,000 cost basis reduction for the fire loss. The fire loss calculations consisted of a self-prepared schedule. Petitioner did not provide verifiable documentation such as insurance reports to support the valuation of the inventory lost in the fire. Since petitioner has not shown that the $53,000 allowed by the Department for inventory losses in the fire is incorrect, we find that the Department has made an adequate allowance for inventory lost in the fire.

Petitioner also argues that the allowance for shrinkage should be increased to 5 percent. We note that the 2010 Report to the Nations on Occupational Fraud and Abuse offered by petitioner in support of its shrinkage argument provides that *16.3 percent* of the 5 percent of asset misappropriation, or 0.82 percent, can be attributed to employee theft. Thus, this evidence does not support an increase to the 2 percent allowance for shrinkage included in the audit calculations.

We find that petitioner has not established that any adjustments are warranted.

OTHER DEVELOPMENTS

None.

Summary prepared by Pete Lee, Business Taxes Specialist II

MARKUP TABLE

Percentage of taxable vs. nontaxable purchases	100% taxable
Mark-up percentages developed	24.59% thru June 07 41.99% beginning July 07
Self-consumption allowed in dollars	$2,688 per quarter, $30,276 total for audit period
Self-consumption allowed as a percent of taxable purchases	Approximately 1%
Pilferage allowed in dollars	$61,360
Pilferage allowed as a percent of taxable purchases	2%