

1 CALIFORNIA STATE BOARD OF EQUALIZATION

2 APPEALS DIVISION BOARD HEARING SUMMARY

3 In the Matter of the Petitions for Redetermination)
4 Under the Sales and Use Tax Law of:)5 AHMAD ABDUL RASHEED, ABED A. AWAD,)
6 GAMELLA A. AWAD, & BASIMA A.)
7 RASHEED, dba R & H Liquor)Account Number SR CH 21-848345
Case ID 553811

8 AWAD & RASHEED, INC., dba R & H Liquor)

Account Number SR CH 101-276639
Case ID 553801

9 Petitioners)

Hayward, Alameda County

10 Type of Business: Liquor store

11 Audit periods: 10/01/06 - 06/30/09 (553811)
12 07/01/09 - 09/30/09 (553801)13 ItemDisputed Amount

553811

553801

14 Unreported taxable sales

\$362,390

\$27,641

15 Negligence penalty

\$ 3,398

\$ 296

TaxPenaltyTaxPenalty

16 As determined and proposed

17 to be redetermined

\$33,975.56

\$3,397.62

\$2,964.78

\$296.47

18 Less concurred

- 1,977.09

00.00

- 269.78

00.00

18 Balance, protested

\$31,998.47\$3,397.62\$2,695.00\$296.47

19 Proposed tax redetermination

\$33,975.56

\$2,964.78

20 Interest through 12/31/12

12,176.60

632.41

20 Negligence penalty

3,397.62296.47

21 Total tax, interest, and penalty

\$49,549.78\$3,893.6622 Monthly interest beginning 01/01/13 \$169.88\$14.82

23 UNRESOLVED ISSUES

24 **Issue 1:** Whether adjustments are warranted to unreported taxable sales. We find no
25 adjustment is warranted.26 Petitioners operated a liquor store. The Sales and Use Tax Department (Department) initiated
27 an audit of the partnership for the period October 1, 2006, through September 30, 2009, but it
28 discovered during the audit that the business had been incorporated July 1, 2009, and that three of the

1 corporate officers were also partners in the predecessor. The Department therefore issued two Notices
2 of Determination for the three-year audit period, one to the partnership for the period October 1, 2006,
3 through June 30, 2009, and one to the corporation for the third quarter 2009 (3Q09).

4 The partnership provided records that appeared substantially complete. However, the
5 Department computed book markups ranging from 16 to 20 percent for the years 2007, 2008, and
6 2009, which were considerably below the 30 to 45 percent range of markups the Department expects
7 for a liquor store. Accordingly, the Department decided to establish taxable sales on a markup basis.

8 The Department adjusted the cost of goods sold reported on the federal income tax returns for
9 the amounts of lottery purchases and check-cashing costs included therein. It reduced the adjusted cost
10 of goods sold by 3 percent for pilferage but made no adjustment for self-consumption since petitioners
11 asserted that there was none. The Department then applied the audited ratio of taxable to total
12 purchases of 87.70 percent (based on a purchase segregation test using purchase invoices for 2Q08) to
13 compute audited cost of taxable goods sold. The Department added the audited markup of 30.05
14 percent, computed in a shelf test, to establish audited taxable sales, which exceeded reported taxable
15 sales by 16.78 percent for 2007, 15.30 percent for 2008, and 12.94 percent for 2009 (15.02 percent for
16 the three years combined). The Department used those percentages of error to compute unreported
17 taxable sales of \$362,390 for the partnership and \$27,641 for the corporation.

18 Petitioners contend that the amount of unreported taxable sales is overstated because the true
19 markup is 25 percent, rather than the 30.05 percent computed in the shelf test, the audited cost of
20 goods sold should be reduced, the audited percentage of taxable to total purchases is excessive, and the
21 allowance for pilferage losses should be computed at 6 to 10 percent. Also, petitioners state that an
22 audit of another liquor store in the area, related to petitioners by a common partner, resulted in no
23 understatement of reported taxable sales. Regarding the markup, petitioners state that the Department
24 computed a 27 percent markup in the most recent prior audit. Also, petitioners assert that the audited
25 markups for liquor and beer should be reduced from 36.47 and 29.64 percent, respectively, to 30
26 percent and 21 percent. As support for their assertion that the audited cost of goods sold amounts are
27 excessive, petitioners have provided amended federal tax returns that show reduced amounts of cost of
28

1 goods sold. Regarding the audited percentage of taxable to total purchases, petitioners assert that 2Q08
2 (the period used for the purchase segregation) was not representative of the entire audit period.

3 When the D&R was issued, we had not reviewed the prior audit and, except for petitioner's
4 claim regarding the markup used in that prior audit, no evidence was provided to show that the
5 Department had computed a markup of 27 percent for that prior audit. Therefore, the D&R does not
6 address how the use of a 27 percent markup in the prior audit might impact our analysis of the markup
7 in the audit in dispute here. However, in its preparation for the Board hearing, the Department found a
8 copy of the No-Change audit report for the period April 1, 2001, through March 31, 2004, in the
9 central file for account number SR CH 21-848345. That report confirms that the Department did, in
10 fact, conduct a shelf test to compute a markup of 27.02 percent in that audit. Accordingly, we now
11 consider whether the lower markup in the audit of the prior period warrants an adjustment of the
12 markup for this audit period.

13 Our experience is that markups often vary for the same business during different audit periods.
14 For example, the mix of products sold by businesses often changes over time, resulting in a
15 corresponding change in the average markup, and such appears to have been the case here. The no-
16 change audit report indicates that 40 percent of petitioner's purchases at the time of those prior tests
17 were tobacco products. That percentage has dropped to 29 percent at the time of the tests during the
18 present audit. Since the markup for cigarettes and tobacco products was the lowest markup of all
19 product categories in the present audit (and, presumably, in the prior audit), the decrease in petitioner's
20 sales of the low-markup products would necessarily result in a higher average markup during the
21 present period (if all other things were equal).

22 The shelf test for the audit in dispute was computed using information from November 2009,
23 just over a month after the end of the audit period here. In contrast, the shelf test for the prior audit
24 was performed in mid-2004, about two years prior to the beginning of the audit period here. We find
25 that the information for November 2009 is more representative for this audit than information for 2004.
26 Accordingly, we find that the somewhat lower audited markup in the prior period (27 percent rather
27 than 30 percent) is not evidence that the markup in this audit should be reduced but indicates, instead,
28 that there were changes in the operation of the business, purchasing patterns, and pricing policies

1 between the two audit periods. On that basis, we recommend no adjustment based on the markup used
2 in the prior audit.

3 With respect to the disputed markups for liquor and beer, we find that the shelf tests provided
4 by petitioners include far fewer products than the shelf tests conducted by the Department. Further, for
5 the products included by petitioners, the markups are the same as those computed by the Department.
6 Thus, we find that the differences in petitioners' computed markups are related to their exclusion of
7 products with higher markups, and that the Department's more inclusive tests are more reliable.
8 Regarding the lower amounts of purchases shown on the amended federal tax returns, petitioners have
9 provided no accounting entries or documentation to support the adjustments it made to the cost of
10 goods sold amounts reported on the original returns. Without that detail, we reject the cost of goods
11 sold amounts shown on the amended returns. With respect to the percentage of taxable to total
12 purchases, we note that petitioners have provided no evidence to support a lower percentage, and the
13 Department's purchase segregation test included a full quarter, which is sufficient to include more than
14 a complete purchasing cycle for a liquor store. Regarding the allowance for pilferage, the Department
15 has already allowed 3 percent, which far exceeds the standard allowance of 1 percent, and petitioners
16 have not provided evidence to support a higher allowance. Moreover, we find that the audit results for
17 another liquor store have no bearing on our analysis of these liabilities. Therefore, we find no
18 adjustments are warranted to the amounts of unreported taxable sales.

19 **Issue 2:** Whether petitioners were negligent. We conclude that they were.

20 The Department imposed negligence penalties because the partnership had been audited three
21 times previously, and the Department established deficiencies in two of those three prior audits that
22 were caused by the same errors the Department found here. Petitioners dispute the negligence penalty
23 because the prior audits indicate a trend of improvement in accurate reporting, although that trend did
24 not continue into this audit period.

25 The partnership was audited for the periods July 1991 through June 1994, January 1996
26 through September 1998, and April 2001 through March 2004. For the latter audit, the Department
27 found no understatement, but for the two former audits, the Department established deficiencies on a
28 markup basis of \$350,864 and \$140,550, respectively. We find that the recurrence of substantial errors

1 in reported taxable sales for the partnership is compelling evidence of negligence for both the
2 partnership and the corporation, since three of the four corporate officers were also partners in the
3 business during the earlier portion of the audit period. We find that the substantial amounts of
4 understatement and the percentages of error of 15.41 percent for the partnership and 12.94 percent for
5 the corporation are additional evidence of negligence. Accordingly, we find that the negligence
6 penalties were properly applied.

7 **OTHER MATTERS**

8 None.

9
10 Summary prepared by Deborah A. Cumins, Business Taxes Specialist III

MARKUP TABLE

Percentage of taxable vs. nontaxable purchases	87.70%
Mark-up percentages developed	30.05%
Self-consumption allowed in dollars	None*
Pilferage allowed in dollars	\$79,702 for the years 2007, 2008, and 2009
Pilferage allowed as a percent of total purchases	3%

* No adjustment has been made for self-consumption because petitioners asserted that there was none, even though the effect of self-consumption in a markup audit was fully explained at the appeals conference.