

CALIFORNIA STATE BOARD OF EQUALIZATION
APPEALS DIVISION FINAL ACTION SUMMARY

In the Matter of the Petition for Redetermination)
Under the Sales and Use Tax Law of:)
EARTH-N-WARE, INC.) Account Number: SR EA 24-969442
Petitioner) Case ID 459938
Orange, Orange County

Type of Business: Cigarette store
Audit period: 01/01/05 – 12/31/07

<u>Item</u>	<u>Disputed Amount</u>
Disallowed claimed exempt sales	\$4,072,455
Unreported cigarette rebates	\$ 182,383 ¹
Negligence penalty	\$ 32,975
Tax as determined and protested:	\$329,749.98
Interest through 8/31/11	143,772.67
Negligence penalty	<u>32,975.02</u>
Total tax, interest, and penalty	<u>\$506,497.67</u>
Monthly interest beginning 9/1/11	<u>\$ 1,648.75</u>

The Board held a hearing regarding this matter on March 23, 2011, granting petitioners 30 days to provide additional records and the Sales and Use Tax Department (Department) 30 days to respond. Also, the Board directed the Department to attempt to locate B & T Services, Inc. (B&T), the Nevada company to which petitioner claimed it had made exempt sales in interstate commerce in excess of \$4 million. Based on petitioner’s submissions and the Department’s response, we do not recommend adjustments, as discussed below under Post Hearing Developments.

UNRESOLVED ISSUES

Issue 1: Whether the claimed exempt sales in interstate commerce were properly disallowed. We find that they were.

¹ Of this amount, the audit allocates \$18,984 to cigarette rebates related to reported taxable sales and \$163,399 to rebates related to disallowed claimed exempt sales in interstate commerce. However, this allocation is not relevant since, as explained below, we find that etitioner has not established that any of the claimed exempt sales were, in fact, exempt.

1 Petitioner operates a cigarette store. During its preliminary examination, the Department found
2 that petitioner's various records substantially reconciled. The Department noted that petitioner had
3 claimed exempt sales in interstate commerce in excess of \$4 million to one customer, B&T. However,
4 petitioner was unable to produce any shipping documents to support the claimed interstate sales.
5 Petitioner stated that there were no shipping documents because it delivered the cigarettes to B&T in
6 Nevada each week. Petitioner further asserted that it had no receipts from the trips because it
7 transported the cigarettes using a van with a large gas tank and thus never had to stop for gasoline or
8 anything else during the approximate five-hour round-trip drive from California to Nevada. The
9 Department found there was insufficient evidence to show that the claimed amounts were, in fact,
10 exempt sales in interstate commerce, and it disallowed the entire amount claimed during the audit
11 period.

12 Petitioner contends that the claimed interstate sales represented valid exempt sales and should
13 not have been disallowed. Petitioner states that all its sales to B&T were sales of cigarettes that
14 petitioner delivered to Nevada. Petitioner further states that it sold only 45-50 cartons of cigarettes per
15 week from its store in California and could not have sold over 700 cartons of cigarettes a week from
16 that location.

17 At the appeals conference, petitioner indicated that it decided to change its business from
18 pottery sales to cigarette sales largely because of discussions with B&T. The theory of the revised
19 business model, petitioner says, was that B&T would be petitioner's primary customer. Petitioner
20 states that it delivered 500 to 800 cartons of cigarettes each week to B&T in Nevada, in exchange for a
21 payment of \$10,000 (with additional amounts, if any, paid the following week). Petitioner asserts it
22 then deposited large amounts of cash into the bank each Monday. According to petitioner, these
23 transactions occurred every Saturday night for approximately 15 years, until B&T learned petitioner
24 was being audited and cut off all contact with petitioner. To support its contentions, petitioner
25 provided four bank statements which show large deposits (greater than \$10,000) each Monday,
26 claiming that the deposits are evidence of large weekly sales to B&T. Petitioner also provided two
27 invoices dated January 6 and 13, 2007, which show sales of cigarettes to B&T, with delivery occurring
28 in Primm, Nevada. Although the invoices include a signature line for the customer, neither invoice is

1 signed. In addition, petitioner provided an undated letter from the corporate president, Suzanne
2 Newton, stating that she recalls that her husband, Gerald Newton, was gone every Saturday night,
3 presumably making cigarette deliveries.

4 Petitioner's evidence simply is not plausible. The large deposits each Monday morning may be
5 evidence of significant sales over the weekend, but they have no evidentiary value with regard to the
6 identity of the customers or the place of sale. We find the invoices unconvincing, first because they
7 are unsigned, and second because petitioner has provided only two invoices despite claiming to have
8 made deliveries to B&T every week for 15 years. Further, we find that the letter from Ms. Newton
9 does not even state that she observed any deliveries of cigarettes to B&T in Nevada. Accordingly, we
10 conclude that the evidence provided by petitioner is insufficient to show that the amounts claimed on
11 returns represented valid exempt sales in interstate commerce (or sales outside California).² With
12 respect to petitioner's statement that it could not have sold over 700 cartons of cigarettes a week out of
13 its store, we note petitioner asserted at the appeals conference that its sales from the store had increased
14 from the 50 cartons of cigarettes per week during the audit period to 300 per week at the time of the
15 appeals conference. Petitioner's only explanation for this increase was word-of-mouth advertising.
16 We find it very unlikely that there was such a dramatic increase in sales based solely on word-of-
17 mouth, with such increase occurring solely after the audit period and after petitioner's alleged
18 relationship with B&T had ended. We find that petitioner has not supported its claimed exempt sales
19 in interstate commerce and that no adjustment is warranted to the disallowed claimed exempt sales.

20 **Issue 2:** Whether adjustments are warranted to the unreported cigarette rebates. We
21 recommend no adjustment.

22 The Department found that the gross receipts reported on petitioner's income tax returns
23 substantially reconciled with the total sales reported on its sales and use tax returns. On the income tax
24 returns, however, the Department noted that petitioner had separately reported rebate income as "other
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27 ² The D&R also considers whether the sales to B&T were nontaxable sales for resale, although petitioner did not raise that
28 contention. The Department has been unable to find any business information about B&T, and there is no dispute that B&T
did not provide petitioner a resale certificate. Thus, the Department concluded the sales were not nontaxable sales for
resale, and we concur.

1 income.” The Department therefore concluded that cigarette rebates were not included in the sales
2 petitioner reported on sales and use tax returns. From petitioner’s records, the Department established
3 total cigarette rebates for the audit period of \$182,383, all of which it treated as taxable.

4 The rebates at issue were issued by the cigarette manufacturers rather than petitioner’s
5 distributors, and they constitute gross receipts to petitioner. Accordingly, they are subject to tax, and
6 petitioner does not argue otherwise. Instead, petitioner contends that it has already paid tax with
7 respect to the cigarette rebates. As support, petitioner has provided pricing sheets, asserting that those
8 sheets show petitioner charged tax reimbursement to its customers on cigarette selling prices that
9 included the rebates.

10 We find that the pricing sheets alone are not proof that tax was properly remitted on the
11 manufacturer’s rebates. As noted previously, the total sales reported for sales and use tax purposes
12 reconciled with the gross receipts reported on income tax returns, and the rebates were reported on the
13 income tax returns as other income *in addition* to gross receipts. Thus, it is clear that the rebates were
14 not included in the total sales reported on sales and use tax returns, and we recommend no adjustment.

15 **Issue 3:** Whether petitioner was negligent. We conclude that it was.

16 The Department imposed the 10-percent penalty for negligence because petitioner failed to
17 maintain any records or documentation supporting the claimed deductions for exempt interstate sales
18 in excess of \$4 million, which represented nearly 90 percent of its total sales. Petitioner disputes the
19 penalty on the basis that it maintained accurate records and made no attempt to deceive the Board or
20 conceal its interstate commerce sales during the audit.

21 Petitioner’s corporate officers have significant business experience in this industry and should
22 have been well aware of the recordkeeping requirements. Nevertheless, petitioner kept virtually no
23 records to support the claimed exempt sales in interstate commerce (not even sales invoices, and no
24 records of delivery outside the state). Also, the understatement of reported taxable sales of \$4,254,838
25 represents an error ratio of 898 percent. We find that the substantial error and the absence of records to
26 support claimed exempt sales are evidence that petitioner was negligent, at least. Thus, we find the
27 penalty was properly applied.

POST HEARING DEVELOPMENTS

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2 With respect to the claimed exempt sales in interstate commerce of \$4,072,455, petitioner
3 stated that the entire amount represented sales to B&T. The Department researched B&T through the
4 Internet and through the Nevada Secretary of State records, and it was unable to locate any information
5 regarding a business named B & T Services, Inc. Since petitioner has provided no evidence to support
6 its claimed exempt sales in interstate commerce and the Department was unable to find evidence that
7 the business even existed, we conclude that no adjustment is warranted with respect to the disallowed
8 claimed exempt sales in interstate commerce.

9 With respect to the issue of whether the taxable cigarette rebates were included in reported
10 taxable sales, petitioner provided several different records after the Board hearing, most of which had
11 been provided previously. Petitioner has not, however, provided contemporaneous cash register
12 receipts or contemporaneous sales tax worksheets to show that the rebates were included in the amount
13 of total sales reported on sales and use tax returns. Further, the available evidence (the reconciliation
14 of gross receipts reported on federal tax returns and total sales reported on sales and use tax returns)
15 indicates that the rebates were not included in reported total sales, as described under Issue 2 above.
16 Specifically, petitioner has stated that it did not report the rebates as income for income tax purposes
17 for 2005, but it did report them as “other income” for 2006 and 2007. For all three years, the gross
18 receipts reported for income tax purposes (excluding “other income”) reconciled with total sales
19 reported on sales and use tax returns, which is strong evidence that total sales reported on sales and use
20 tax returns did not include any cigarette rebates. Accordingly, we recommend no adjustment to the
21 audited amount of unreported taxable cigarette rebates.

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