

CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION SUMMARY FOR BOARD HEARING

In the Matter of the Petition for Redetermination)
 Under the Sales and Use Tax Law of:)
 RAMI MICHELL DARGHALLI and FAIZ) Account Number: SR Y AR 97-883995
 MOHAMED MUNASSAR,) Case ID 404172
 dba Smoke 4 Less #2)
 Petitioner) Lancaster, Los Angeles County

Type of Business: Tobacco stores

Audit Period: 10/1/02 – 12/31/03

<u>Item</u>	<u>Amount in Dispute</u>		
Unreported sales	\$623,963		
Unreported sales of other tobacco products	\$54,734		
	<u>Tax</u>	<u>Penalties</u>	
As determined	\$63,226.23	\$7,673.86	
Adjustments: Sales and Use Tax Department	-1,456.90	-220.32	
Appeals Division	-1,775.22	-256.23	
Proposed redetermination	\$59,994.11	\$7,197.31	
Amount concurred in	-4,001.61	-7,197.31 ¹	
Protested	\$55,992.50	\$ 0.00	
Proposed tax redetermination	\$59,994.11		
Interest through 1/31/11	39,011.45		
Negligence penalty	5,999.42		
Amnesty double negligence penalty	1,197.89		
Amnesty interest penalty	829.54		
Total tax, interest, and penalties	<u>\$107,032.41</u>		
Monthly interest beginning 2/1/11	<u>\$349.97</u>		

This matter was scheduled for Board hearing on May 27, 2009, but was postponed so that the Sales and Use Tax Department (Department) could review new information provided by the Board's Investigations Division regarding additional purchases of other tobacco products made by petitioner that were not accounted for in the audit. The Department prepared a reaudit as discussed below under "Other Developments." The matter was then rescheduled for Board hearing on July 15, 2010, but

¹ At the appeals conference, petitioner specifically conceded that it was negligent.

petitioner waived its appearance at the hearing. Accordingly, the Board Proceedings Division informed petitioner that this matter would be presented to the Board for decision without oral hearing. Subsequently, petitioner contacted the Board Proceedings Division to request a Board hearing because it had new documentation to present to the Board. This matter was rescheduled for Board hearing on November 17, 2010, but petitioner again waived its appearance, and thus, was informed that this matter would be presented to the Board for decision without oral hearing. Subsequently, petitioner's representative contacted the Board Proceedings Division to request that this matter again be placed on the oral hearing calendar.

UNRESOLVED ISSUE

Issue: Whether adjustments are warranted to the unreported taxable sales. We recommend no further adjustments.

During the audit, based on the gross receipts and costs petitioner reported on its federal income tax returns, the Department calculated petitioner's book markups as -26.384 percent for 2002 and -13.235 percent for 2003 (-19.460 percent overall for the two years). Since a negative book markup means that the records reflect sales of goods at prices below cost, the Department concluded that petitioner's reported sales were substantially understated and decided to establish taxable sales on a markup basis. The Department conducted a shelf test to calculate a cigarette markup of 11.70 percent, and it estimated markups of 65 percent for cigars and 50 percent for miscellaneous taxable merchandise. Using percentages of purchases in each category, as established in a purchase segregation test for a related business, the Department calculated an overall weighted average audited markup for taxable merchandise of 13.902 percent.

To establish audited merchandise purchases, the Department first computed petitioner's cigarette purchases, using cigarette purchases from Philip Morris and a calculated percentage of cigarette purchases from Philip Morris to total cigarette purchases. It then divided total cigarette purchases by 95.811 percent, the audited ratio of cigarette purchases to total merchandise purchases, based on the aforementioned purchase segregation test for the related business. The audited merchandise purchases of \$696,354 for 2002 and \$827,670 for 2003 exceeded recorded purchases by 111.423 percent. The Department reduced audited merchandise purchases for 2003 by \$85,000 for a

1 documented theft based on a police report. The D&R recommended an additional adjustment for a
2 documented theft of \$24,200 for 2002 and adjustments for shrinkage, computed at 1 percent, and for
3 the cost of self-consumed merchandise, estimated at \$100 per month. Using those adjusted audited
4 amounts of merchandise purchases and the audited markup of 13.902 percent, the Department
5 computed unreported taxable sales of \$701,715.

6 Petitioner contends that the amount of unreported taxable sales is excessive, arguing that the
7 Department's analysis is based on erroneous assumptions. Petitioner explains its partners operated
8 several other tobacco shops, liquor stores, and mini-marts in the area during the period at issue.
9 Petitioner asserts that, although these businesses were separate entities with separate seller's permits,
10 petitioner regarded them as branches of the same general business and bought merchandise in bulk
11 through one store for distribution to several of its locations. Petitioner claims these bulk purchases
12 were generally recorded on the purchasing store's books, but that, following delivery of the
13 merchandise by the vendor, the merchandise was physically divided among several store locations.

14 Petitioner has not provided any evidence of the alleged inventory transfers between businesses.
15 Since the individuals in the partnerships who owned the related businesses were not identical, we
16 believe inter-company transfers would have been reflected in the books of each entity, and unrecorded
17 transfers would be unlikely because the transfers (or lack thereof) would have had a direct bearing on
18 the net profit or loss of each entity. In addition, petitioner stated that several of the related entities
19 were audited concurrently with this account. Based on the Board's computerized records, we were
20 able to identify three related accounts which were audited, and those audits were all performed on a
21 mark-up basis. Since the alleged transfers were not recorded or otherwise identified in any of the
22 books of the related entities, it is evident that the measure of tax related to the alleged inter-company
23 transfers of merchandise has not been duplicated in the audits of the related businesses.

24 Moreover, we note that most of the related businesses are liquor stores, which generally do not
25 sell cigarettes in volumes as large as a store specializing in sales of cigarettes and tobacco products.
26 We therefore believe that, if petitioner had actually made any transfers of cigarettes to a related entity,
27 the transfer would have been to a sole proprietorship operated by Mr. Darghalli (Smoke 4 Less, SR Y
28 AR 97-264029), which also specialized in sales of cigarettes and tobacco products. Since the statute of

1 limitations has not expired for Smoke 4 Less, any recommended adjustment for a transfer of inventory
2 to Smoke 4 Less would essentially just shift the tax liability from one account to another and would
3 have a minimal overall tax consequence. In any event, we find that petitioner has not established any
4 such inventory transfer and we conclude that no further adjustments are warranted.

5 **AMNESTY**

6 Petitioner did not participate in the amnesty program, and an amnesty double negligence
7 penalty of \$1,276.58 was included in the determination. (Rev. & Tax. Code § 7073, subd. (c).) This
8 penalty has been reduced to \$1,197.89 as a result of the second reaudit discussed under "Other
9 Developments." An amnesty interest penalty of \$1,018.22 will be imposed when the liability becomes
10 final. (Rev. & Tax. Code § 7074, subd. (a).) Petitioner has indicated that it does not protest any
11 amnesty penalty that might apply. Nevertheless, we informed petitioner of the provisions for relief of
12 amnesty penalties under section 6592; petitioner responded that it would not request relief of these
13 penalties. However, pursuant to the Board's order at its meeting on March 18, 2008, we recommend
14 that \$188.68 of the amnesty interest penalty, which is the portion related to cigarette rebates, be
15 relieved provided that, within 30 days of the Notice of Redetermination, petitioner either pays the
16 amnesty-eligible portion of the tax and interest related to cigarette rebates or enters into a qualifying
17 installment agreement to do so and successfully completes that agreement. We find there is no basis to
18 recommend relief of the remainder of the amnesty penalties.

19 **OTHER DEVELOPMENTS**

20 Prior to the Board hearing scheduled on May 27, 2009, the Investigations Division found, and
21 informed the Department, that petitioner had purchased other tobacco products from an out-of-state
22 supplier, The House of Oxford, which were not included in the audit of petitioner. Based on its
23 review, the Department concurred with the findings of the Investigations Division. Thus, in a second
24 reaudit, the Department used the additional purchases to compute taxable sales of other tobacco
25 products of \$54,734, but this was more than offset by other adjustments in petitioner's favor. The
26 Department reduced the audited markup for sales of cigars, adjusted the selling price of cigarettes for
27 inflation, and recalculated audited taxable sales, and increased self consumption from \$1,500 to
28 \$3,000, which resulted in reducing the understatement of reported taxable sales from \$701,715 to

1 \$623,963. The increase for the additional purchases and the decrease for the other adjustments
2 reduced the audited taxable measure of \$748,719 from the first reaudit measure to a measure of
3 \$727,201 in the second reaudit (\$623,963 for unreported taxable sales, \$54,734 for the separately
4 stated sales of other tobacco products established in the second reaudit, \$3,000 for self consumption of
5 cigarettes, and \$45,504 for unreported taxable cigarette rebates), or a further reduction in tax from
6 \$61,769.33 to \$59,994.11. Petitioner has not specifically protested the separately stated amount of
7 unreported taxable sales of other tobacco products. The evidence shows that these purchases were not
8 recorded in petitioner's books and records, and in the absence of arguments or evidence regarding this
9 issue, we recommend no adjustment to the separately stated amount of unreported taxable sales of
10 other tobacco products.

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12 Summary prepared by Rey Obligacion, Retired Annuitant
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MARKUP TABLE

Percentage of taxable vs. nontaxable purchases	100% *
Mark-up percentage developed	12.983%
Self-consumption allowed in dollars	\$3,000
Self-consumption allowed per month per location	\$100 per month
Pilferage allowed in dollars	\$13,100
Pilferage allowed as a percent of total purchases	1%
Theft supported by police reports	\$109,200

* Unreported taxable sales were established on analysis of taxable purchases only. Petitioner did claim exempt food sales of \$6,960 for the audit period while reporting taxable sales of \$290,822 on his sales and use tax returns. Based on petitioner's sales and use tax returns, exempt sales represent 2.393 percent of reported taxable sales.

Exhibit 1
SR Y AR 97-883995

Account Number	Business Name	Type of Ownership	Owner or Partners	Start Date	Close-out Date
SR AP 97-887887	Frontier Liquor	Sole proprietor	Rami Michell Darghalli	9/1/2001	Active
SR AR 97-905806	Business Center Chevron	Sole proprietor	Rami Michell Darghalli	7/1/2001	Active
SR AC 100-397416	Ben's Liquor	Sole proprietor	Rami Michell Darghalli	6/1/2004	12/31/2007
SR Y AR 97-264029	Smoke 4 Less	Sole proprietor	Rami Michell Darghalli	7/1/1998	6/28/2004
SR AR 99-942157	Challenger Liquor	Partnership	Rami M. Darghalli & Abdulkarim R. Maida	7/22/1996	Active
SR AR 100-257395	Bobs Too Market	Partnership	Rami M. Darghalli & Mashhour Mashhour	7/1/2003	Active
SR AC 100-260697	Stan's Liquors	Partnership	Rami M. Darghalli & Simon Y. Akraa	9/1/2003	Active
SR AR 97-534491	Village Liquor	Partnership	Rami M. Darghalli, Mashhour Mashhour & Sumaleh Mashhour	5/1/1999	5/19/2008
SR AR 99-778442	Bob's Too Liquor	Partnership	Rami M Darghalli, Naim Mashhour & Eyda Mashhour	10/1/1995	Active
SR Y AR 100-204203	Tastee Subs, Inc.	Corporation		4/1/2003	9/30/2006