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CALIFORNIA STATE BOARD OF EQUALIZATION

SUMMARY DECISION UNDER REVENUE AND TAXATION CODE SECTION 40

In the Matter of the Petition for Redetermination)	Case ID's:	569235, 570251
And Administrative Hearing Under the Cigarette)	Oral hearing date:	September 23, 2014
and Tobacco Products Tax Law of:)	Decision rendered :	December 20, 2014
MOX, INC., dba Max Wholesale)	Publication due by:	April 20, 2015
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Petitioner/Taxpayer ¹)		
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Representing the Parties:

For Taxpayer:	Todd Luoma, Attorney Betty Williams, Attorney
For Investigations and Special Operations Division:	Pamela Mash, Tax Counsel
For Appeals Division:	Jeffrey G. Angeja, Tax Counsel IV

LEGAL ISSUE 1

Whether taxpayer is liable for tax on its distributions of tobacco products in California.

FINDINGS OF FACT AND RELATED CONTENTIONS

Taxpayer held a cigarette and tobacco products distributor's account that became effective May 1, 2004. Although taxpayer filed returns throughout the period that the account was active, it did not report any distributions of tobacco products in California.

On October 17, 2006, a search warrant was executed at Sunrise Tobacco in Phoenix, Arizona.² The records seized included three bills of lading and various sales invoices from which the Board's Investigations and Special Operations Division (ISOD) established that taxpayer had purchased tobacco products from Sunrise Tobacco totaling \$5,927,391 during the period May 1, 2004, through February 28, 2006.

¹ For ease of reference, we will use the term "taxpayer" throughout the Summary Decision.
² The search warrant was executed as part of a joint investigation with the United States Department of Justice, Bureau of Alcohol, Tobacco, Firearms, and Explosives, the Arizona Department of Revenue, the Federal Bureau of Investigation, and the Phoenix Police Department.

1 The three bills of lading that were obtained from Sunrise Tobacco were created by ABF Freight
2 Systems, Inc., and list pick up-dates in January and February 2006. They identify Sunrise Tobacco as
3 the shipper and Max Wholesale as the consignee. On each bill of lading, the contact person listed is
4 “Lee,” with the same phone number adjacent to the name on each bill of lading. The ship-to address
5 for Max Wholesale on all three documents is a Los Angeles property owned by taxpayer’s president,
6 Kwang Yi. ISOD also obtained four sales invoices from January 2006 that show “Lee” in the box
7 marked “Ship to.” Also, in a document that ISOD determined was a Sunrise Tobacco customer list,
8 there is an entry of “Lee,” with a phone number that, according to Board records, belongs to Kwang
9 Yi. Based on the available evidence, ISOD concluded that taxpayer’s president, Kwang Yi, goes by
10 the nickname of “Lee” or “Mr. Lee.” With regard to the period May 1, 2004, through December 31,
11 2005, ISOD noted that 105 sales invoices from Sunrise Tobacco state that the items are to be shipped
12 to “Lee,” “Lee-LA,” “L-LA,” or “L.” ISOD determined that taxpayer made those purchases as well,
13 and issued the determinations at issue herein.

14 Taxpayer contends that it did not purchase tobacco products from Sunrise Tobacco. As
15 support, taxpayer has submitted a letter from Sunrise Tobacco’s president, Akrum Alrahib, that states
16 Mr. Alrahib did not sell tobacco products to Kwang Yi and that he primarily sold tobacco to two
17 individuals, Ali Tavaf and Ahmad Darwish. Mr. Alrahib acknowledges that a few deliveries were
18 shipped to Mr. Yi but states that the deliveries were made to Mr. Yi for the sole purpose of forwarding
19 the product on to other Los Angeles customers. Taxpayer argues that “Lee” on the invoices and bills
20 of lading refers to Ali Tavaf, since Mr. Tavaf was a customer of Sunrise Tobacco and the name “Ali”
21 is derived from the Arabic root “L-Y.” Taxpayer further argues that Mr. Yi’s telephone number was
22 listed on the bills of lading because the product was delivered to Mr. Yi for subsequent pickup by
23 Mr. Tavaf or Mr. Darwish. Taxpayer further asserts that the fact the telephone number adjacent to
24 “Lee” on certain documents matches the number in the Board’s records for Mr. Yi is not evidence that
25 Mr. Yi is “Lee.” In short, taxpayer contends that ISOD has not established that the purchases were
26 made by taxpayer or that taxpayer made distributions of tobacco products in California.

27 In response, ISOD states that records seized from Sunrise Tobacco include handwritten papers
28 that list balances for and payments made by “Lee.” In addition, one of ISOD’s investigators states that

1 Mr. Yi answered to “Mr. Lee” when she met with him, and Danny Kim, a special agent of the
2 California Department of Justice, has confirmed that Mr. Yi identified himself during an interview as
3 Mr. Lee. Further, ISOD has submitted a document found in the records seized at Sunrise Tobacco,
4 titled “Reconstruction of Monthly Sales for August 1, 2005, to January 31, 2006, Based on Average
5 Mark Up and Percentages of Sales Volume,” which lists sales to several California businesses,
6 including Max Wholesale.

7 Taxpayer disputes ISOD’s conclusion that Mr. Yi uses the nickname “Mr. Lee,” asserting that
8 Mr. Yi has limited English-language capabilities and the fact that he may have answered to “Mr. Lee”
9 could be due to a misunderstanding. Taxpayer also asserts that any reference to Mr. Yi’s response to
10 the name “Mr. Lee” is hearsay and therefore should be disregarded. Further, taxpayer questions the
11 validity of the evidence cited by ISOD. Moreover taxpayer notes that the reconstruction of monthly
12 sales document shows purchases by Max Wholesale of only \$371,736 for the period August 1, 2005,
13 through January 31, 2006, which represents average monthly purchases of \$61,596, which are well
14 below ISOD’s estimated purchases for taxpayer. As a result, taxpayer argues that the reconstruction of
15 monthly sales is evidence that ISOD’s estimate should be reduced.

16 APPLICABLE LAW

17 The Cigarette and Tobacco Products Tax Law (Law) requires every person desiring to engage
18 in the sale of cigarettes or other tobacco products (hereafter tobacco products) to apply with the Board
19 for a distributor’s license. (Rev. & Tax. Code, § 30140.) The Law additionally imposes upon every
20 distributor a tax, based on the wholesale cost of the tobacco products, upon the distribution of tobacco
21 products. (Rev. & Tax. Code, §§ 30101, 30123, 30131.2.) “Distributor” includes every person who
22 distributes tobacco products, or who sells or accepts orders for tobacco products that are to be
23 transported from a point outside this state to a consumer within this state. (Rev. & Tax. Code, §
24 30011.) The term “distribution” includes (1) the sale of untaxed cigarettes or tobacco products in this
25 state, (2) the “use or consumption” of untaxed cigarettes or tobacco products in this state, and (3) the
26 placing in this state of untaxed cigarettes or tobacco products in a vending machine or in a retail stock
27 for the purpose of selling the products to consumers. (Rev. & Tax. Code, § 30008.) “Use or
28 consumption” includes the exercise of any right or power over tobacco products incident to the

1 ownership thereof, other than the sale of the tobacco products or the keeping or retention thereof by a
2 licensed distributor for the purpose of sale. (Rev. & Tax. Code, § 30009.) Unless the contrary is
3 established, it shall be presumed that all tobacco products acquired by a distributor are untaxed tobacco
4 products, and that all tobacco products manufactured in this state or transported to this state, and no
5 longer in the possession of the distributor, have been distributed. (Rev. & Tax. Code, § 30109.)

6 ANALYSIS AND DISPOSITION

7 We find that the evidence shows taxpayer accepted numerous deliveries of untaxed tobacco
8 products from Sunrise Tobacco and taxpayer operated a business selling tobacco products, which is
9 evidence that taxpayer made sales of tobacco products and/or placed untaxed tobacco products in his
10 retail stock for the purpose of selling those products to consumers. (See Rev. & Tax. Code, § 30008,
11 subs. (a), (c).) Taxpayer has not presented any argument or evidence rebutting the presumption that
12 the tobacco products purchased from Sunrise Tobacco were untaxed and that taxpayer distributed these
13 products. Therefore, we find that taxpayer is liable for excise taxes on any untaxed tobacco products
14 that taxpayer distributed during the liability periods.

15 We conclude that taxpayer made the purchases in question. In that regard, taxpayer provided
16 no evidence that the tobacco products were shipped to taxpayer for the sole purpose of forwarding the
17 product to other Los Angeles customers or that “Lee” refers to Ali Tavaf. We reject taxpayer’s
18 assertion that the name “Lee” and the various permutations of that name on the invoices and bills of
19 lading do not refer to Mr. Yi. We find the totality of the evidence, detailed above, supports ISOD’s
20 conclusions regarding this matter. Accordingly, we find taxpayer made the purchases of untaxed
21 tobacco products in question and is liable for the tax on its distribution of those products.

22 Moreover, given that taxpayer failed to report its distributions of untaxed tobacco products and
23 did not provide complete records, we also find that ISOD used the best evidence available to estimate
24 the wholesale cost of tobacco products distributed by taxpayer. We reject taxpayer’s argument that the
25 amount of purchases should be based on the reconstruction of monthly sales document. While we
26 accept that document as definitive proof that taxpayer purchased tobacco products from Sunrise
27 Tobacco, we find the amounts shown thereon to be unreliable since the bills of lading alone indicate
28 purchases of \$331,477 by taxpayer from Sunrise Tobacco for January 2006, which far exceeds the

1 purchases of \$61,956 reflected by the reconstruction of monthly sales. Thus, the bills of lading and
2 invoices used by ISOD to establish the amount of purchases represent the most reliable evidence
3 available.

4 LEGAL ISSUE 2

5 Whether ISOD has provided clear and convincing evidence of fraud.

6 FINDINGS OF FACT AND RELATED CONTENTIONS

7 ISOD imposed 25-percent penalties on taxpayer (a penalty of \$597,264.09 for the period
8 May 1, 2004, through December 31, 2005, and a penalty of \$95,647.93 for the period January 1, 2006,
9 through February 28, 2006) for fraud or intent to evade tax based on a finding that taxpayer
10 intentionally avoided paying tax on his distributions of untaxed tobacco products, pursuant to Revenue
11 and Taxation Code section 30224.

12 Specifically, ISOD notes that taxpayer opened a seller's permit (SR AA 100-254330) from
13 May 1, 2003, to April 30, 2004, dba LA One Trading. ISOD states that taxpayer closed this permit
14 because it was incorporating the business, and, upon close out, the business was re-opened by
15 taxpayer's president, Mr. Yi, on May 1, 2004, under a new seller's permit (SR AA 100-387209), dba
16 Max Wholesale. ISOD states that this indicates that taxpayer was aware of the proper licensing
17 requirements for their business operations and entity changes. ISOD states that it sent a letter to
18 taxpayer on April 27, 2004, informing taxpayer how to be compliant with AB 71,³ and ISOD notes that
19 this letter correctly defined "cigarette distributor," "cigarette wholesaler," "tobacco products
20 distributor," and "tobacco products wholesaler," which provided notice to taxpayers of its obligations
21 under the Law.

22 In addition, by letter dated June 16, 2004, ISOD provided taxpayer with further information on
23 the taxability of tobacco products, the reporting requirements, which persons were required to pay the
24 tax, along with the definition of a tobacco products distributor and the types of products that are
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27 ³ The Cigarette and Tobacco Products Licensing Act of 2003 is also known as Assembly Bill Number 71 (AB 71). (Stats.
28 2003, ch. 890, § 1.)

1 taxable as tobacco products. This letter also included several relevant Board publications⁴ that advise
2 taxpayers of the taxes applicable to distributions of cigarette and tobacco products.

3 Furthermore, ISOD notes that taxpayer filed Tobacco Distributor's Tax Returns for June 2004
4 through December 2005. ISOD states that these returns explain the taxability of tobacco products, the
5 definition of "tobacco products," the reporting requirements, and how to complete the tax return.
6 ISOD states that each month's return came with these instructions and explanations, giving taxpayer
7 the knowledge and understanding needed to comply with its tax reporting and tax payment obligations
8 as a tobacco products distributor.

9 ISOD determined that taxpayer's failure to report any distributions of tobacco products despite
10 taxpayer's aforementioned knowledge of its obligation to do so was the result of fraud. Accordingly
11 ISOD imposed the fraud penalties at issue herein.

12 On appeal, taxpayer argues that it did not underreport its liability as a tobacco product
13 distributor during the period in which it held a tobacco product distributor's license. Therefore,
14 taxpayer argues that the fraud penalties should be removed.

15 APPLICABLE LAW

16 Revenue and Taxation Code section 30224 provides for the addition of a 25-percent penalty if
17 any part of a deficiency determination is due to fraud or intent to evade the Law or authorized rules or
18 regulations. Fraud is intentional wrongdoing on the part of the taxpayer with the specific intent to
19 avoid a tax known to be due. (*Bradford v. Commissioner* (9th Cir. 1986) 796 F.2d 303, 307
20 (*Bradford*); see Sales and Use Tax Department Audit Manual (Audit Manual) § 0509.10.)⁵ Fraud must
21 be established by clear and convincing evidence. (*Cal. State Bd. of Equalization v. Renovizor's Inc.*
22 (9th Cir. 2002) 282 F.3d 1233, 1241; *Marchica v. State Bd. of Equalization* (1951) 107 Cal.App.2d
23 501, 508; see Cal. Code Regs., tit. 18, § 1703, subd. (c)(3)(C).)⁶ Although fraud may not be presumed,

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25 ⁴ The publications were: Publication 4, *California Cigarette and Tobacco Products Tax Law*; Publication 15, *California*
26 *Cigarette and Tobacco Products Tax Regulations*; and Publication 93, *Cigarette and Tobacco Products Tax*.

27 ⁵ Although the Audit Manual was issued for the Sales and Use Tax Department, for purposes of consistent tax
28 administration, the Board applies the same standard in Cigarette and Tobacco Products Tax cases.

⁶ Although this is a Sales and Use Tax Regulation, for purposes of consistent tax administration, the Board applies the same
standard in Cigarette and Tobacco Products Tax cases.

1 it is rare to find direct evidence that fraud has occurred and thus it is often necessary to make the
2 determination based on circumstantial evidence. (*Bradford, supra*, 796 F.2d at p. 307; *Tenzer v.*
3 *Superscope, Inc.* (1985) 39 Cal.3d 18, 30; see Audit Manual § 0509.25.) Where there is a substantial
4 deficiency that cannot be explained satisfactorily as being due to an honest mistake or to negligence
5 and where the only reasonable explanation is a willful attempt to evade the payment of tax, the penalty
6 for fraud or intent to evade the tax applies. The size of the deficiency in relation to the tax reported
7 should be taken into account, and the indication that a deficiency is due to intent to evade increases in
8 direct proportion to the ratio of the understatement, when it cannot otherwise be satisfactorily
9 explained. Certain facts or actions are by nature evidence of a deliberate attempt to evade the payment
10 of tax, including falsified records and failure to follow the requirements of the law, the knowledge of
11 which is evidenced by permits or licenses held by a taxpayer in prior periods. (*Bradford, supra*, 796
12 F.2d at p. 307; see Audit Manual §§ 0509.20, 0509.25.)

13 ANALYSIS AND DISPOSITION

14 We have already concluded above that taxpayer distributed untaxed tobacco products in
15 California, for which it owes excise tax. During both liability periods, taxpayer failed to report its
16 distributions of untaxed tobacco products. Thus, if taxpayer was aware that it owed excise tax on its
17 distributions, the fraud penalty must be upheld. Here, while taxpayer has not argued that it did not
18 know that it would be liable for excise tax on any distributions it made, in the above-referenced
19 correspondence dated April 27, 2004, and June 16, 2004, ISOD specifically advised taxpayer that
20 excise tax applies to distributions of cigarettes and other tobacco products. In addition, taxpayer filed
21 Tobacco Products Distribution Tax Returns for every month during the period May 1, 2004, through
22 December 31, 2005, and each return was sent to taxpayer with instructions explaining the reporting
23 and tax payment obligations applicable to distributions of cigarettes and other tobacco products.
24 Therefore, petitioner's monthly filing of these returns clearly demonstrates taxpayer's knowledge of
25 the licensing and tax requirements imposed on cigarettes and other tobacco product distributions.
26 Thus, we find that taxpayer knew that tobacco product retailers and distributors must be licensed and
27 that sales or distributions without a license were a violation of the law.

1 In addition to knowledge of the licensing and tax requirements imposed on tobacco products
2 distributors, taxpayer must have known that the tobacco products were untaxed because it purchased
3 them from an unlicensed vendor. However, taxpayer wholly failed to report any distributions or pay
4 any amount of tax during the liability periods. The complete failure to report anything at all is beyond
5 negligent error and instead is a strong indication of fraud. On the basis of the foregoing, we find that
6 taxpayer knew what was required by the Cigarette and Tobacco Products Tax Law, knew that its
7 actions were in violation of that law, and intended by its actions to evade the subject taxes.

8 In summary, we find that ISOD has established taxpayer's fraud for both liability periods by
9 clear and convincing evidence, and we conclude that the fraud penalties are warranted.

10 ORDER

11 Pursuant to the analysis of the law and facts above, the Board ordered that the determined tax
12 and fraud penalties be redetermined without further adjustment.

13 Adopted at Sacramento, California, on December 18, 2014.

14 Jerome E. Horton _____, Chairman

15 Michelle Steel _____, Member

16 Betty T. Yee _____, Member

17 George Runner _____, Member

18 John Chiang _____, Member