

CALIFORNIA STATE BOARD OF EQUALIZATION

SUMMARY DECISION UNDER REVENUE AND TAXATION CODE SECTION 40

In the Matter of the Petition for Redetermination)	Case ID:	564308
Under the Sales and Use Tax Law of:)	Oral hearing date:	March 28, 2017 ¹
)	Decision rendered :	May 13, 2017
PUBLIC MOTORS LOS ANGELES, LLC)	Publication due by:	September 10, 2017
)		
Petitioner)		

Representing the Parties:

For Taxpayer: Appearance Waived

For Business Taxes and Fee Department: Appearance Waived

For Appeals Division: Jeffrey G. Angeja, Tax Counsel IV

LEGAL ISSUE 1

Whether any further adjustments to the amount of unreported taxable sales are warranted.

FINDINGS OF FACT AND RELATED CONTENTIONS

Petitioner operated a used car dealership from November 2004 until December 2008. Petitioner made retail sales of used vehicles by holding a public auction every Sunday, and also made retail sales to customers who visited its retail vehicle lot. For audit, petitioner provided general ledgers, federal income tax returns (FITR's), and vehicle deal jackets for February 2007. The Business Tax and Fee Department (Department), formerly the Sales and Use Tax Department, noted that gross receipts reported on petitioner's FITR's substantially exceeded reported total sales on the sales and use tax returns. The Department scheduled sales tax reimbursement recorded in the general ledgers and reduced that amount by the amount of sales tax reimbursement accrued on sales that were reversed (unwinds), among other adjustments. In total, the Department established unreported taxable sales of \$14,556,319 in the post-D&R reaudit.

¹ At the Board meeting, the Board voted unanimously to redetermine the liability without further adjustment.

1 Petitioner contends that additional adjustments are warranted for unwinds. Petitioner also
2 contends that unreported taxable sales should be reduced to allow for bad debts. In support, petitioner
3 provided a worksheet in which it computed bad debts of \$797,738 using the pro rata method relating to
4 357 of its used vehicle sales. In addition, petitioner asserts that sales are accurately recorded in the
5 general ledgers, and thus, the \$491,148 measure of tax based on the difference between the gross
6 receipts reported on its 2008 FITR and its recorded total sales should be deleted.

7 APPLICABLE LAW

8 California imposes sales tax on a retailer's retail sales in this state of tangible personal property,
9 measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from
10 taxation by statute. (Rev. & Tax. Code, § 6051.) All of a retailer's gross receipts are presumed subject
11 to tax unless the retailer can prove otherwise. (Rev. & Tax. Code, § 6091.) When the Board is not
12 satisfied with the accuracy of the tax returns filed, it may base its determination of the tax due upon the
13 facts contained in the return or upon any information that comes within its possession. (Rev. & Tax.
14 Code, § 6481.) It is the taxpayer's responsibility to maintain and make available for examination on
15 request all records necessary to determine the correct tax liability, including bills, receipts, invoices, or
16 other documents of original entry supporting the entries in the books of account. (Rev. & Tax. Code,
17 §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698, subd. (b)(1).) Where the Board establishes a
18 deficiency, the burden of proof is on the taxpayer to explain the disparity between the taxpayer's books
19 and records and the results of the Board's audit. (*Riley B's, Inc. v. State Board of Equalization* (1976)
20 61 Cal.App.3d 610, 615-616.)

21 Additionally, a retailer is relieved from liability for sales tax that became due and payable,
22 insofar as the measure of the tax is represented by accounts that have been found to be worthless and
23 charged off for income tax purposes by the retailer or, if the retailer is not required to file income tax
24 returns, charged off in accordance with generally accepted accounting principles. (Rev. & Tax. Code,
25 § 6055.) California Code of Regulations, Title 18, section (Regulation) 1642 explains the proper
26 methods of computing bad debts. A retailer may claim a bad debt deduction, provided that the sales
27 tax had been paid to the state on such bad debt accounts. Subdivision (b) of Regulation 1642 states
28 that if the amount of an account found to be worthless and charged off is comprised in part of

1 nontaxable receipts such as interest, insurance, repair, or installation labor and in part of taxable
2 receipts upon which tax has been paid, a bad debt deduction may be claimed only with respect to the
3 unpaid amount upon which tax has been paid. In determining that amount, all payments and credits to
4 the account may be applied ratably against the various elements comprising the amount the purchaser
5 contracted to pay (pro rata method), may be applied as provided in the contract of sale (contract
6 method), or may be applied by another method which reasonably determines the amount of the taxable
7 receipts (alternative method). Subdivision (f) of Regulation 1642 states that when there is a
8 repossession, a bad debt deduction is allowable to the extent that the retailer sustains a net loss of gross
9 receipts upon which tax has been paid. This will be when the amount of all payments and credits
10 allocated to the purchase price of the merchandise, including the wholesale value of the repossessed
11 item, is less than that price. If the pro rata method is used to apply payments, a retailer incurs an
12 allowable bad debt deduction if the wholesale value of the repossessed merchandise is less than the net
13 contract balance (excluding unearned insurance and finance charges) at the date of repossession. If the
14 contract method is used to apply payments, a retailer incurs an allowable bad debt deduction if the
15 wholesale value of the repossessed merchandise is less than the net contract balance at the date of
16 repossession. An alternative method can be used to compute a bad debt loss subject to Board approval.
17 Subdivision (e) of Regulation 1642 explains that, in support of deductions or claims for credit for bad
18 debts, a retailer must maintain adequate and complete records showing, among other things: (1) the
19 date of original sale; (2) the name and address of the purchaser; (3) the amount the purchaser
20 contracted to pay; (4) the amount on which the retailer paid tax; (5) all payments or other credits
21 applied to the account of the purchaser; and (6) evidence that the uncollectible portion of gross receipts
22 on which tax was paid actually has been legally charged off as a bad debt in accordance with
23 Regulation 1642.

24 ANALYSIS AND DISPOSITION

25 We find that the sales tax accrual account in petitioner's general ledgers is evidence of
26 petitioner's sales, and thus, the Department was justified in using this source to compute petitioner's
27 sales. With regard to the alleged additional unwinds, petitioner has not provided any documentation or
28 other evidence to demonstrate that it is entitled to additional adjustments for unwinds, and thus, we

1 recommend no adjustment. While petitioner provided a worksheet showing its computation of bad
2 debts, it did not provide any documentary evidence showing that the amounts listed on the worksheet
3 were charged off as bad debts for income tax purposes in accordance with California Code of
4 Regulations, title 18, section 1642, subdivision (e)(7). Therefore, we recommend no adjustments for
5 bad debts. With respect to petitioner's contention that unreported taxable sales based on the difference
6 between gross receipts reported on the 2008 FITR and recorded total sales should be deleted, we find
7 that gross receipts reported on petitioner's FITR's are evidence of its sales. Petitioner has not provided
8 any documentation to show that the additional reported gross receipts represented nontaxable sales,
9 and thus, we have no basis on which to recommend a reduction. Accordingly, we recommend no
10 further reduction to the measure of unreported taxable sales.

11 LEGAL ISSUE 2

12 Whether any further adjustments to the amount of unreported purchases of consumable supplies
13 subject to use tax are warranted.

14 FINDINGS OF FACT AND RELATED CONTENTIONS

15 The Department noted that petitioner reported use tax on purchases totaling \$9,632 on its sales
16 and use tax returns for the fourth quarter of 2008 (4Q08). The Department concluded that petitioner
17 likely made ex-tax purchases of consumable supplies subject to use tax in other quarterly periods, and,
18 based on its experience in similar audits, estimated that petitioner owed use tax on 20 percent of its
19 purchases of consumable supplies. The Department applied the estimated ratio of 20 percent to
20 petitioner's recorded consumable supply purchases of \$514,771 to compute audited ex-tax purchases
21 of consumable supplies subject to use tax of \$102,954 for the audit period, which exceeded petitioner's
22 reported ex-tax purchases subject to use tax by \$93,320 (rounded). However, after the appeals
23 conference, petitioner provided some purchase invoices from a related account for the year 2007.
24 Based on the available purchase invoices, the Department reduced the ratio of consumable supply
25 purchases subject to use tax from 20 percent to 5.67 percent in the post-D&R reaudit, which resulted in
26 a reduction to the amount of unreported consumable supply purchases subject to use tax, from \$93,320
27 to \$19,556.

28 Petitioner contends that it paid tax to its vendors on all of its purchases of consumable supplies,

1 and that the measure of tax should be reduced to zero.

2 APPLICABLE LAW

3 Use tax is imposed upon the storage, use, or other consumption of tangible personal property in
4 this State. (Rev. & Tax. Code, § 6201.) A person who stores, uses, or otherwise consumes tangible
5 personal property in this state is liable for the tax. (Rev. & Tax. Code, § 6202, subd. (a).) A person's
6 liability for the use tax is not extinguished until: 1) the tax has been paid to the state; or 2) the person is
7 given a receipt for the tax from a retailer engaged in business in this state or from a retailer who is
8 authorized by the Board to collect the tax. (Rev. & Tax. Code, § 6202, subd. (a).)

9 When the Board is not satisfied with the accuracy of tax returns filed, it may base its
10 determination of the tax and penalties due upon the facts contained in the return or upon any
11 information that comes within its possession. (Rev. & Tax. Code, § 6481; *Maganini v. Quinn* (1950)
12 99 Cal.App.2d 1, 7.) Where the Board establishes a deficiency, the burden is upon the taxpayer to
13 explain the disparity between the books and records and the results of the Board's audit. (*Riley B's,*
14 *Inc. v. State Board of Equalization* (1976) 61 Cal.App.3d 610, 615-16.)

15 ANALYSIS AND DISPOSITION

16 We note that petitioner reported purchases subject to use tax of \$9,632 on line 2 of its sales and
17 use tax returns for 4Q08. Thus, we find that petitioner did not pay tax to its vendors on all of its
18 purchases of consumable supplies. The adjustments in the post-D&R reaudit are based on a review of
19 purchase invoices included in the audit of a related account, which was operated in a similar manner as
20 petitioner's business. Petitioner has not provided any purchase invoices to support its contention that it
21 paid tax to its vendors on all of its purchases of supplies, and has not provided any evidence to support
22 a further reduction. Thus, we recommend no additional reduction to the measure of tax for unreported
23 purchases of consumable supplies subject to use tax.

24 LEGAL ISSUE 3

25 Whether any further adjustments to the amount of unreported purchases of capital assets
26 subject to use tax are warranted.

27 FINDINGS OF FACT AND RELATED CONTENTIONS

28 Using petitioner's depreciation schedules from its FITR's, the Department scheduled capital

1 asset purchases of \$14,252. Since petitioner failed to provide any purchase invoices, the Department
2 concluded that petitioner owed use tax on all of the purchases of capital assets.

3 Petitioner contends that it paid tax to its vendors on all of its purchases of capital assets, and
4 that the measure of tax should be reduced to zero.

5 APPLICABLE LAW

6 Use tax is imposed upon the storage, use, or other consumption of tangible personal property in
7 this state. (Rev. & Tax. Code, § 6201.) A person who stores, uses, or otherwise consumes tangible
8 personal property in this state is liable for the tax. (Rev. & Tax. Code, § 6202, subd. (a).) A person's
9 liability for the use tax is not extinguished until: 1) the tax has been paid to the state; or 2) the person is
10 given a receipt for the tax from a retailer engaged in business in this state or from a retailer who is
11 authorized by the Board to collect the tax. (Rev. & Tax. Code, § 6202, subd. (a).)

12 When the Board is not satisfied with the accuracy of tax returns filed, it may base its
13 determination of the tax and penalties due upon the facts contained in the return or upon any
14 information that comes within its possession. (Rev. & Tax. Code, § 6481; *Maganini v. Quinn* (1950)
15 99 Cal.App.2d 1, 7.) Where the Board establishes a deficiency, the burden is upon the taxpayer to
16 explain the disparity between the books and records and the results of the Board's audit. (*Riley B's,*
17 *Inc. v. State Board of Equalization* (1976) 61 Cal.App.3d 610, 615-16.)

18 ANALYSIS AND DISPOSITION

19 Petitioner has not provided any evidence, such as purchase invoices, to show that it paid tax to
20 its vendors on any of the capital assets at issue here. As a result, we have no basis on which to
21 recommend an adjustment.

22 LEGAL ISSUE 4

23 Whether petitioner was negligent.

24 FINDINGS OF FACT AND RELATED CONTENTIONS

25 Initially, the Department imposed a 40-percent fraud penalty (see Rev. & Tax. Code, § 6597)
26 for petitioner's failure to remit sales tax reimbursement of \$645,739.18 that it had collected during the
27 periods January 1, 2007, through December 31, 2007, and July 1, 2008, through December 31, 2008,
28

1 and imposed the negligence penalty on the remaining audit liability.² The Department imposed the
2 negligence penalty for the periods January 1, 2006, through December 31, 2006, and January 1, 2008,
3 through June 30, 2008, because petitioner failed to properly report sales and sales tax reimbursement
4 recorded in its own records, and the understatement occurred in every reporting period. Additionally,
5 the Department imposed the negligence penalty because petitioner failed to maintain complete sales
6 contracts and purchase invoices to support amounts recorded in its general ledger. Subsequently,
7 based on the Department's concession, we recommended that the 40-percent penalty be replaced with
8 the negligence penalty applied to the liability for the entire audit period. Petitioner contends that the
9 understatement was due to employee turnover at the controller position and was not due to negligence.

10 APPLICABLE LAW

11 Revenue and Taxation Code section 6484 provides that if any part of the deficiency for which a
12 deficiency determination is made is due to negligence or intentional disregard of the law or authorized
13 rules and regulations, a penalty of 10 percent of the amount of the determination shall be added
14 thereto. Negligence is the failure to act with due care and to do what the average prudent
15 businessperson would do under the same or similar circumstances. (Sales and Use Tax Department
16 Audit Manual (Audit Manual) § 0506.10.) The negligence penalty is applicable where a taxpayer is
17 found to be negligent in keeping records or where a taxpayer is found to be negligent in preparing
18 returns, or both. (Audit Manual § 0506.45.)

19 A taxpayer shall maintain and make available for examination on request by the Board all
20 records necessary to determine the correct tax liability under the Sales and Use Tax Law, and all
21 records necessary for the proper completion of the sales and use tax returns. (Rev. & Tax. Code,
22 §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698, subd. (b)(1).) Such records include, but are not
23 limited to: the normal books of account ordinarily maintained by the average prudent businessperson
24 engaged in the activity in question; bills, receipts, invoices, cash register tapes, or other documents of
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26 _____
27 ² Petitioner also collected and retained sales tax reimbursement of \$433,612 during the period January 1, 2006, through
28 December 31, 2006. However, the 40-percent penalty provided by Revenue and Taxation Code section 6597 was not
effective until January 1, 2007, and thus, the Department did not apply the 40-percent penalty for the year 2006.

1 original entry; and, schedules of working papers used in connection with the preparation of the tax
2 returns. (Cal. Code Regs., tit. 18, § 1698, subd. (b)(1).) Failure to maintain and keep complete and
3 accurate records will be considered evidence of negligence and may result in penalties. (Cal. Code
4 Regs., tit. 18, § 1698, subd. (k).)

5 In analyzing the issue of negligence, one of the factors that must be considered is whether or
6 not the taxpayer has been previously audited. (Audit Manual § 0506.35.) Generally, a taxpayer who
7 has not been previously audited is treated with more leniency than a taxpayer who has been previously
8 audited. However, all other relevant factors, such as the general state of the books and records and the
9 taxpayer's business experience, must be considered, and where the evidence clearly shows that the
10 understatement is due to negligence, then the penalty applies even when the taxpayer has not been
11 previously audited. (Audit Manual § 0506.35.) In the case at hand, petitioner has had no previous
12 examination or audit.

13 ANALYSIS AND DISPOSITION

14 We note that petitioner collected and retained sales tax reimbursement on more than
15 \$13 million in taxable sales, which is clear and convincing evidence of at least negligence, if not fraud.
16 More specifically, petitioner recorded the accrued sales tax reimbursement on those sales (\$1,077,053)
17 in its own general ledger and therefore, petitioner had actual knowledge of the unremitted tax.
18 Additionally, we note that the unremitted sales tax reimbursement for the audit period averaged
19 approximately \$89,754 per quarter, and represented 27.94 percent of the total sales tax reimbursement
20 that petitioner collected. We find that petitioner's failure to remit more than one-fourth of the sales tax
21 reimbursement it collected from its customers during the audit period to be very strong evidence of at
22 least negligence.

23 Additionally, we note that, for 2006 and 2007, the difference between petitioner's recorded and
24 reported taxable sales was even greater than the discrepancies found in its sales tax accrual account,
25 since the taxable sales recorded in petitioner's own general ledgers exceeded taxable sales computed
26 from the sales tax accrual account by \$943,134, and we find that petitioner must have known of its
27 own recorded sales. We also note that petitioner's failure to provide complete sales contracts and
28 purchase invoices for the entire audit period is strong evidence of negligence in recordkeeping.

1 We note that a negligence penalty is warranted even in a first-time audit, when the evidence
2 establishes that the taxpayer could not have held a good-faith, reasonable belief that it was accurately
3 reporting its sales and use tax obligations. (*Cf. Independent Iron Works, Inc. v. State Bd. of*
4 *Equalization* (1959) 167 Cal.App.2d 318, 321-324.) Here, petitioner’s *own records* show that it
5 collected and accrued over \$1,000,000 in sales tax reimbursement without remitting it, and it recorded
6 even more taxable sales that it failed to report. Accordingly, petitioner knew it was not accurately
7 reporting its sales and use tax obligations, and certainly could not have held a good-faith, reasonable
8 belief that it was doing so. As a result, the evidence clearly and convincingly establishes that
9 petitioner was at least negligent, and the negligence penalty is warranted.

10 ORDER

11 Pursuant to the analysis of the law and facts above, the Board ordered that the negligence
12 penalty be sustained and that the tax be redetermined without further adjustment.

13 Adopted at Sacramento, California, on June 20, 2017.

14 Diane Harkey _____, Chairwoman

15 George Runner _____, Member

16 Fiona Ma _____, Member

17 Jerome Horton _____, Member

18 Yvette Stowers _____, Member*

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25 *For Controller Betty Yee, pursuant to Government Code section 7.9.
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