

**CALIFORNIA STATE BOARD OF EQUALIZATION**

**SUMMARY DECISION UNDER REVENUE AND TAXATION CODE SECTION 40**

In the Matter of the Petition for Redetermination	)	Case ID:	569627
Under the Sales and Use Tax Law of:	)	Oral hearing date:	January 24, 2017 <sup>1</sup>
	)	Decision rendered :	March 15, 2017
<b>PUBLIC MOTORS ORANGE COUNTY, LLC</b>	)	Publication due by:	July 13, 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 September 2004 until December 2015. 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) 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 \$6,757,253.

Petitioner contends that additional adjustments are warranted for unwinds. Petitioner also

<sup>1</sup> At the oral hearing, the Board voted unanimously to delete the negligence penalty and redetermine the liability without further adjustment.

1 contends that unreported taxable sales should be reduced to allow for bad debts. To support an  
2 adjustment for bad debts, petitioner provided a worksheet in which it computed bad debts of  
3 \$95,998.35 related to 550 sales of used vehicles.

4 APPLICABLE LAW

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

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

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

#### 21 ANALYSIS AND DISPOSITION

22 We find that the sales tax accrual account in petitioner's general ledgers is evidence of  
23 petitioner's sales, and thus, the Department was justified in using this source to compute petitioner's  
24 sales. With regard to the alleged additional unwinds, petitioner has not provided any documentation or  
25 other evidence to demonstrate that it is entitled to additional adjustments for unwinds, and thus, we  
26 recommend no adjustment. With respect to bad debts, we note that petitioner claimed a bad debt of  
27 \$2,209 on its FITR for 2006, but did not provide any documentation to show that this amount related to  
28 a taxable transaction. While petitioner provided a worksheet showing other bad debts, it did not

1 provide any documentary evidence showing that any of the transactions listed on the worksheet were  
2 charged off as bad debts for income tax purposes in accordance with Regulation 1642, subdivision  
3 (e)(7). In the absence of sufficient evidence to support bad debt losses from taxable sales, we  
4 recommend no adjustment for bad debts. Accordingly, we recommend no further reduction to the  
5 measure of unreported taxable sales.

6 LEGAL ISSUE 2

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

9 FINDINGS OF FACT AND RELATED CONTENTIONS

10 The Department noted that petitioner reported use tax on purchases totaling \$97,342 on its sales  
11 and use tax returns during the period April 1, 2005, through December 31, 2005. While the  
12 Department found that petitioner likely made additional ex-tax purchases of consumable supplies  
13 subject to use tax in other quarterly periods, it found that it was required to estimate the amount of the  
14 ex-tax purchases because petitioner did not provide any purchase invoices for the audit period. Based  
15 on its experience in similar audits, the Department estimated that petitioner owed use tax on 20 percent  
16 of its purchases of consumable supplies. The Department applied its estimated ex-tax purchase ratio of  
17 20 percent to total recorded consumable supply purchases of \$768,386 for the period January 1, 2006,  
18 through March 31, 2008, to compute unreported ex-tax purchases of consumable supplies subject to  
19 use tax of \$153,677 for the period January 1, 2006, through March 31, 2008. For the period April 1,  
20 2005, through December 31, 2005, the Department accepted the accuracy of petitioner's reported  
21 purchases subject to use tax.

22 After the appeals conference, petitioner provided some purchase invoices for the year 2007.  
23 Based on the available purchase invoices, the Department recommended reducing the ratio of  
24 consumable supply purchases subject to use tax from 20 percent to 5.67 percent of petitioner's  
25 recorded purchases of consumable supplies. In the post-D&R reaudit, unreported consumable supply  
26 purchases subject to use tax were reduced by \$110,108 to \$43,571.

27 Petitioner contends that it paid tax on all of its purchases of consumable supplies, and thus, the  
28 measure of tax should be reduced to zero.

1 APPLICABLE LAW

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

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

14 ANALYSIS AND DISPOSITION

15 We note that petitioner self-reported purchases subject to use tax totaling \$97,342 on its sales  
16 and use tax returns for the period April 1, 2005, through December 31, 2005. Thus, we find that  
17 petitioner did not pay tax to its vendors on all of its purchases of consumable supplies. The  
18 Department's concession that the ex-tax purchase ratio should be reduced to 5.67 percent of total  
19 recorded purchases is based on its review of the purchase invoices the petitioner provided for the year  
20 2007. Petitioner has not provided any additional purchase invoices to show that tax was paid to its  
21 vendors on all of the remaining purchases of supplies, and has not provided any other evidence to  
22 support an additional reduction. Thus, we recommend no additional reduction to the measure of tax  
23 for unreported 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 federal income tax returns, the Department

1 scheduled capital asset purchases totaling \$181,953. Since petitioner failed to provide any purchase  
2 invoices, the Department concluded that petitioner owed use tax on all of the purchases of capital  
3 assets. Based on its examination of purchase invoices provided by petitioner after the appeals  
4 conference, the Department reduced unreported capital asset purchases subject to use tax by \$1,000,  
5 from \$181,953 to \$180,953, in the post-D&R reaudit.

6 Petitioner contends that a purchase of a capital asset for \$140,649 on March 31, 2006, shown in  
7 its depreciation schedules is computer equipment and software that it does not own, and therefore, it  
8 does not owe use tax on the purchase. According to petitioner, the computer equipment and software  
9 is owned by another company located in Canada. Petitioner provided a copy of a contract dated  
10 January 4, 2006, for the purchase of computer equipment and software for a total of \$52,642, which it  
11 contends represents a portion of the asset purchase of \$140,649. In rebuttal, the Department contends  
12 the invoice provided by petitioner supports the fact petitioner purchased taxable computer equipment  
13 and software subject to use tax.

#### 14 APPLICABLE LAW

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

21 When the Board is not satisfied with the accuracy of tax returns filed, it may base its  
22 determination of the tax and penalties due upon the facts contained in the return or upon any  
23 information that comes within its possession. (Rev. & Tax. Code, § 6481; *Maganini v. Quinn* (1950)  
24 99 Cal.App.2d 1, 7.) Where the Board establishes a deficiency, the burden is upon the taxpayer to  
25 explain the disparity between the books and records and the results of the Board's audit. (*Riley B's,*  
26 *Inc. v. State Board of Equalization* (1976) 61 Cal.App.3d 610, 615-16.)

#### 27 ANALYSIS AND DISPOSITION

28 We have reviewed the contract provided by petitioner and we note that the contract is for

1 petitioner's purchase of computer equipment, software license, and hardware/software maintenance for  
2 a lump-sum price of \$52,642, excluding taxes and freight. Petitioner has neither provided evidence to  
3 show that sales or use tax was paid on the purchase, nor provided any evidence to determine whether  
4 the hardware/software maintenance contracts were exempt from tax. Regarding petitioner's contention  
5 that the equipment is owned by another company, we find that the fact that petitioner depreciated the  
6 equipment is strong evidence that petitioner purchased the equipment. Furthermore, petitioner has not  
7 provided any additional invoices to show that tax was paid on any of the remaining asset purchases.  
8 Based on the foregoing, we recommend no additional adjustments.

9 LEGAL ISSUE 4

10 Whether petitioner was negligent.

11 FINDINGS OF FACT AND RELATED CONTENTIONS

12 The Department imposed the negligence penalty because petitioner failed to properly report  
13 sales recorded in its own records, and failed to maintain complete sales contracts and purchase invoices  
14 to support amounts recorded in its general ledger. Petitioner asserted that the understatement was the  
15 result of employee turnover and not the intent to defraud the state.

16 APPLICABLE LAW

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

25 A taxpayer shall maintain and make available for examination on request by the Board all  
26 records necessary to determine the correct tax liability under the Sales and Use Tax Law, and all  
27 records necessary for the proper completion of the sales and use tax returns. (Rev. & Tax. Code,  
28 §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698, subd. (b)(1).) Such records include, but are not

1 limited to: the normal books of account ordinarily maintained by the average prudent businessperson  
2 engaged in the activity in question; bills, receipts, invoices, cash register tapes, or other documents of  
3 original entry; and, schedules of working papers used in connection with the preparation of the tax  
4 returns. (Cal. Code Regs., tit. 18, § 1698, subd. (b)(1).) Failure to maintain and keep complete and  
5 accurate records will be considered evidence of negligence and may result in penalties. (Cal. Code  
6 Regs., tit. 18, § 1698, subd. (k).)

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

#### 15 ANALYSIS AND DISPOSITION

16 We find that petitioner's failure to provide complete sales contracts and purchase invoices for  
17 the entire audit period is evidence of negligence in recordkeeping. Also, a comparison of unreported  
18 taxable sales of \$6,757,253 with reported taxable sales of \$33,169,858 shows a reporting error rate of  
19 20.37 percent, which is additional evidence of negligence. Nevertheless, because this is petitioner's  
20 first audit, we find that petitioner is entitled to leniency and we conclude that the penalty should be  
21 deleted.



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ORDER

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

Adopted at Culver City, California, on April 25, 2017.

Diane Harkey \_\_\_\_\_, Chairwoman

George Runner \_\_\_\_\_, Member

Fiona Ma \_\_\_\_\_, Member

Jerome Horton \_\_\_\_\_, Member

Yvette Stowers \_\_\_\_\_, Member\*

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