

**M e m o r a n d u m**

**To** : Mr. Ramon J. Hirsig  
Executive Director (MIC 73)

**Date:** August 11, 2005

**From** : Randie L. Henry, Deputy Director  
Sales and Use Tax Department (MIC 43)

**Subject** : **Proposed Revisions to Audit Manual Chapter 4**

In accordance with the established procedures for audit and compliance manual revisions, I am submitting the proposed revisions to Audit Manual Chapter 4, *General Procedures*, for your approval to place the revisions on the August 31, 2005 Administrative Agenda as a consent item. Upon your approval, we will submit the revisions to the Board Proceedings Division no later than August 16, 2005.

The revisions have been reviewed and approved by SUTD management, provided to the Board Members and posted on the website at <http://www.boe.ca.gov/sutax/staxmanuals.htm> to solicit comments from the public. No comments were received. I have notified the Board Members of our intention to include the revisions on the August 31, 2005 Administrative Agenda.

The revisions are summarized below. Copies of the revisions and related exhibits are attached for your reference.

**Summary of Revisions**

- **AM Section 0401.25.** Provides that without a subpoena or the taxpayer's permission auditors may not access files to which the taxpayer has forbidden access.
- **AM Section 0401.35.** Instructs auditors how to handle suspected money laundering activities.
- **AM Section 0402.25.** Explains when auditors should ask the taxpayer to sign form BOE-146, Waiver of Credit Interest.
- **AM Section 0403.05.** Updates the term "subdistrict" with "branch office."
- **AM Section 0403.10.** Adds IRIS screens and the Internet as sources for obtaining taxpayer information before starting the audit.
- **AM Section 0403.12.** Advises auditors to discuss how summary records are maintained during the initial meeting with the taxpayer.
- **AM Section 0403.16.** Explains Board policy on contact with taxpayers represented by counsel.

- **AM Section 0404.10.** Refers auditors to new Exhibit 11 for sample audit programs for general retailers, manufacturers and wholesalers, and liquor stores.

Deletes last paragraph explaining whether testing should be expanded or completed. The information is out of context in this section and is already included in AM sections 0405.15, Short Tests, and 0405.20, Use of a Test Basis.

- **AM Section 0405.23.** Explains that separate forms BOE-472, Audit Sampling Plans, should be completed for each audit area tested.
- **AM Section 0405.27.** Explains when auditors may request records directly from a taxpayer's financial institution.
- **AM Section 0405.33.** Updates titles for the reorganization of the Sales and Use Tax Department.
- **AM Section 0406.60.** Updates concessionaire section for May 30, 2001 revisions to Regulation 1699, *Permits*.
- **AM Section 0408.25.** Refers auditors to Compliance Policy and Procedure Manual section 830.005 for specific examples of how penalty and interest may apply to use tax due on vehicle purchases.
- **AM Section 0408.27.** Advises auditors that certain property tax records can be useful as another source of asset information.
- **AM Section 0409.51.** Explains that new form BOE-504-BPA, Cover Letter for Special Printing Aids XYZ Letter, is to be sent with special printing aid XYZ letters.  
Provides that XYZ responses should be included in the audit working papers as subsidiary schedules.
- **AM Section 0409.63.** Provides that when the Board plans to assess tax on a purchaser for an improperly given resale certificate, the auditor must make a copy of the resale certificate given by the purchaser to the seller.
- **AM Section 0410.10.** Replaces the term "remittance advices" with "other documents demonstrating direct payment by the United States" to conform to the March 23, 2004 revisions to Regulation 1614, *Sales to the United States and Its Instrumentalities*.
- **AM Section 0410.15.** Provides that the General Services Administration "GSA SmartPay" program is effective through November 28, 2008.
- **AM Section 0411.25.** Updates titles for the reorganization of the Sales and Use Tax Department.
- **AM Section 0414.12.** Advises auditors to send a copy of returned BOE-52, Certificate of Verification of Out-of-State Delivery, to the Audit Support Unit when forms are received from Arizona, Mexico, New Mexico, Oklahoma, Texas or Utah.
- **AM Section 0417.07.** Explains that form BOE-52-L2, Notice of Pending Refund of Excess Tax Reimbursement can be used as an acknowledgement by customers of the retailer's intention to refund excess tax reimbursement.

- **AM Section 0419.15.** Deletes bullet section stating that a purchaser of receivables can not claim a bad debt deduction. Refers auditors to new AM section 0419.17 for information on lender bad debts.
- **AM Section 0419.17.** Explains audit procedures for bad debt deductions claimed by lenders.
- **AM Section 0419.20.** Updates the section to reflect the Board's policy of generally not questioning the validity of tax imposed by another state.
- **AM Section 0419.30.** Updates Property Tax Section name.
- **AM Sections 0419.35 and 0419.40.** Deletes sections. The information is included in AM chapter 6, *Vehicle, Vessel, and Aircraft Dealers* and should not be duplicated in AM chapter 4.
- **AM Section 0419.45.** Explains audit procedures for section 6388 and 6388.5 exemptions for new and remanufactured trucks, truck tractors, trailers and semitrailers.
- **AM Section 0419.50.** Updates procedures for verifying tax exemption cards with the U.S. State Department, Office of Foreign Missions.
- **AM Section 0419.55.** Deletes section. The information is included in AM chapter 8, *Bars and Restaurants* and should not be duplicated in AM chapter 4.
- **AM Sections 0431.00, 0432.00 and 0433.00.** Updates various sections in accordance with the change in the point of prepaid sales tax on fuel. Effective January 1, 2002, prepaid sales tax is imposed on the first removal of fuel at the terminal rack or upon entry into California.
- **AM Section 0432.45.** Explains the time periods the fuel exemption for watercraft common carriers was in effect, discontinued and then reinstated.
- **AM Section 0435.00.** Explains audit procedures under the reinstated Managed Audit Program.
- **Exhibit 1.** Revises box 14 and 15 to show that the audit review function has been transferred from Headquarters to the field offices.
- **Exhibits 2, 3, 5, 9, 12 and 13.** Replaces the following forms with new versions:
  - BOE-1164, Audit Memorandum of Possible Tax Liability
  - BOE-1032, Information on Out-of-State Retailers
  - BOE-472, Audit Sampling Plan
  - BOE-504-CPA, Statement Concerning Property Purchased without Payment of California Sales Tax – Special Printing Aids
  - BOE-504-CFS, Statement Concerning Property Purchased without Payment of California Sales Tax (feed, fertilizer)
  - BOE-837, Affidavit for Section 6388 or 6388.5 Exemption

- BOE-526, Managed Audit Program Participation Agreement  
Adds new form BOE-504-BPA (cover letter for form BOE-504-CPA).
- **Exhibits 4 and 6.** Updates titles and section names for the reorganization of the Sales and Use Tax Department.
- **Exhibit 11.** Deletes form BOE-379-A exhibit. Form was related to section 0419.40 that was deleted. Information regarding exempt sales of aircraft is in AM chapter 6, *Vehicle, Vessel, and Aircraft Dealers*.  
Adds sample audit programs for general retailers, manufacturers and wholesalers, and liquor stores.
- **Exhibit 14C.** Adds form BOE-52-L2, Notice of Pending Refund of Excess Sales Tax Reimbursement as an exhibit.
- **Exhibit 15.** Adds sample memo to be sent regarding suspected money laundering activity. Related to AM section 0401.35 revisions.

Attached are copies of these proposed revisions.

We request your approval to forward these proposed changes to the Board Proceedings Division for placement on the next Administrative Agenda as a consent item.

If you have any questions, please let me know or contact Mr. Jeffrey McGuire at 323-8690.

Approved:



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Ramon J. Hirsig  
Executive Director

Attachment

cc: (all without attachments)  
Ms. Freda Orendt (MIC 47)  
Mr. Stephen R. Rudd (MIC 46)  
Mr. Jeffrey L. McGuire (MIC 92)  
Mr. Vic Anderson (MIC: 44)  
Mr. Geoffrey E. Lyle (MIC: 50)

BOARD APPROVED  
At the Month Day, Year Board Meeting

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Deborah Pellegrini, Chief  
Board Proceedings Division

## **AUTHORITY — EXAMINATION OF RECORDS & ISSUANCE OF SUBPOENAS 0401.25**

Government Code sections 15618 authorizes an auditor to examine records of the taxpayer and of persons doing business with the taxpayer. Revenue and Taxation Code section 7054 provides additional authority for the examination of records pertaining to the sales and use tax. Similar provisions are found in other tax and fee programs administered by the Board.

Government Code section 15613 authorizes the Board to issue a subpoena for the attendance of witnesses or to produce books, records, accounts and papers.

By developing a good working relationship with the taxpayer, an auditor should rarely have to rely on a subpoena as a means of obtaining records. However, if-if a taxpayer refuses to make requested records available, or places undue restrictions or conditions on their use, the auditor's supervisor should be consulted immediately. Once notified, the supervisor should request the necessary records from the taxpayer and explain to the taxpayer, either verbally or in writing, the relevance of the records being requested. If the taxpayer continues to deny access to necessary records, the District Principal Auditor should ~~prepare a written request~~ send a letter to the taxpayer detailing the specific records being requested and the relevance of the records, including a reasonable compliance date. If the taxpayer fails to comply with ~~the~~ this request, the District Administrator may request the issuance of a subpoena duces tecum based on the specific records ~~refereneed~~ detailed in the District's previous letter.

Without a subpoena or the taxpayer's/representative's permission, under no circumstances should the auditor take it upon herself/himself to review, schedule, photocopy, or otherwise access information from files to which the taxpayer has "forbidden" access.

Requests for the issuance of subpoenas must be made by District Administrators and submitted to the Chief, ~~of~~ Field Operations Division or the Chief, Collections and Third District Operations Manager Division for approval and forwarding to the Legal ~~Division~~ Department. When the Legal Department has prepared the subpoena, it will be forwarded to the requester with complete instructions for service. Further information concerning the subpoena process, authority and use is contained in Exhibit 4 — Policy and Procedure For Subpoena Requests.

## **MONEY LAUNDERING**

**0401.35**

In cooperation with the Department of Justice, the Board has agreed to provide assistance in the enforcement of money laundering violations by reporting suspected violations. If potential violations of money laundering or monetary instrument transaction reporting laws are suspected, a report documenting the suspected violation should be prepared and forwarded to the Chief, of Field Operations Division or the Chief, Collections and Third District Operations-Manager Division. That office will then forward the report to the Department of Justice. This report should be submitted in a form similar to that shown in Exhibit 15.

The law contains two money laundering offenses that staff should look for when conducting their regular functions. These are referred to as the "facilitation" offense and the "capturing" offense.

The facilitation offense includes conducting or attempting to conduct a transaction involving a monetary instrument or instruments exceeding \$5,000 through a financial institution with the intent to promote, manage, establish, carry on or facilitate the promotion, management, establishment or carrying on of any criminal activity.

The capturing offense involves the laundering of illegally derived proceeds. It includes conducting or attempting to conduct a transaction involving a monetary instrument or instruments exceeding \$5,000 through a financial institution with knowledge that the monetary instrument represents the proceeds of criminal activity.

Auditors should not spend a significant amount of time investigating potential money laundering violations. However, any suspected violations which are discovered in the course of regular auditing procedures should be reported.

**Claims For Refund.** The taxpayer should always be allowed a reasonable time in which to support a claim for refund. Under most circumstances, ninety days is considered reasonable.

If the taxpayer has been granted a ninety-day delay and requests additional time, consideration should be given to obtaining a waiver of credit interest. The Board may require a claimant to sign a Form BOE-146, Waiver of Credit Interest, as a condition to deferring action on a claim for refund (Revenue and Taxation Code section 6908(b)). In some cases, it may be appropriate to allow up to an additional ninety days because of the size of the claim and large amount of supporting detail required. However, delays beyond six months should not be allowed without a waiver of credit interest or the approval of the Deputy Director, Sales and Use Tax Department, or designee.

An extension of time beyond twelve months from the date the taxpayer was first notified in writing to compile the necessary data in support of the claim should not be allowed even if the taxpayer is willing to sign a waiver of credit interest or an extension to an existing waiver of credit interest. If the taxpayer does not provide the supporting data within the twelve-month period, the claim for refund will be denied for failure to support the grounds upon which the claim was based. Exceptions to this policy must be approved by the Deputy Director, Sales and Use Tax Department, or designee.

**Deficiency Audits With Credits.** If the taxpayer contends that there are other credits which offset or exceed a deficiency disclosed by an audit in process and requests a delay to obtain information supporting such credits, completion of the audit may be delayed for up to ninety days. A notation should be made on the BOE-414-Z of the date and reason for the delay. Should the taxpayer request a further delay, the deficiency audit should be completed as a non-concurred audit and processed in the usual manner.

With regard to the credits in question, it is critical that the auditor obtain a timely claim for refund which includes the taxpayer's specific contentions. The claim for refund, and when appropriate a waiver of credit interest, should be forwarded to the Audit Determination and Refund Section with all pertinent information concerning the credits and the waiver of credit interest. Subsequent action by the district office, if any, will be requested by Headquarters.

It should be noted that refunds are to be considered priority assignments. In those cases where a taxpayer has given the Board a waiver, it becomes even more imperative that prompt action be taken.

**Authorized Signatory.** To preclude any question about the validity of a waiver, the Form BOE-146, Waiver of Credit Interest, must be signed by (1) the taxpayer in the case of a sole proprietorship, (2) a partner in the case of a partnership, (3) a corporate officer in the case of a corporation, or (4) someone holding a written power of attorney from one of those persons.

The essential elements of a valid written power of attorney are:

1. The document must be dated and identified as a "power of attorney."
2. The document must clearly authorize the agent (controller, assistant controller, or some other person) to act in a manner consistent with the signing of a waiver. Ideally, the power of attorney will authorize the agent to act in "sales and use tax matters." However, a less specific description may be acceptable if it can reasonably be interpreted to impose upon the agent the right to execute the Form BOE-146, Waiver of Credit Interest.

3. The person granting the power of attorney must be the owner, partner, or a corporate officer of the company being audited.

With respect to corporations, if the title of the person signing the waiver is other than chairman of the board, president, secretary, or chief financial officer, the auditor must verify, by examining the corporate articles or bylaws regarding corporate officers, that the titled position constitutes a corporate officer.

With respect to partnerships, if the person signing the waiver is not listed as a partner on the IRIS TAR AI screen, the auditor will verify the validity of the person's status as a partner by reviewing the partnership agreement. Any changes in partners must be reported to district compliance as provided in section 0219.03.

*A copy of the written power of attorney must be obtained and attached to the copy of the waiver(s), Form BOE-146, and transmitted to Headquarters with the audit report if the waiver signatory is other than a corporate officer, partner or owner.*

## STARTING AN ASSIGNMENT — GENERAL

0403.05

~~Usually~~ Generally, an assignment should be started only after proper arrangements have been made in advance. In rare instances, it may be desirable to start an assignment without notifying the taxpayer, as in the case of a surprise investigation of a person suspected of fraudulent reporting practices.

If the necessary records are located in an area handled by another district or ~~subdistrict~~ branch office, the audit assignment normally should be transferred to that district or ~~subdistrict~~ branch office along with Form BOE-579. This form should be accompanied by a fact sheet setting forth as much pertinent information as is available, including any audit memoranda, that will assist the receiving office in completing the case. The auditor's supervisor may, in unusual circumstances, ~~make~~ arrangements for the auditor to ~~make~~ conduct the audit at the other location.

## PRELIMINARY ARRANGEMENTS

0403.10

Certain preliminary steps to be taken before starting an assignment are:

- (a) If available, examine the district master file to determine type of business, starting date, ownership, close outs, reorganizations, and general record of reporting; and to review refund notices, delinquencies, audit memos, etc. Taxpayer information may also be obtained electronically by reviewing:
- The IRIS TPS TP screen for prior audit information and petition and claim for refund status. If an appeal is noted, check the APL PR screen for more information.
  - The IRIS COM BA screen for comments input from all IRIS subsystems. If payment problems are noted, the auditor may request that compliance staff review the account on ACMS for additional information.
  - The Internet to find information on company history, product lines, store locations, recent mergers and acquisitions, etc.
- (b) Contact the taxpayer to arrange for:
- Exact time for starting assignment.
  - Records to be supplied for start of assignment.
  - Name and position of person to be contacted. *(The auditor must leave ~~their~~ his or her name and telephone number with the taxpayer at this time.)*
  - Desk space/work area.
- (c) Verify registration information, including:
- ~~Insuring~~ The current ownership is the same as the permit. Sole proprietors may not know that becoming a partnership or incorporating is a change in ownership.
  - The accuracy of the assigned area code(s).
  - The accuracy and currency of all subpermits.
  - The correctness of the taxpayer's local and transit tax allocation procedures.
  - Any other area(s) which could impact the accuracy of the reported local tax.

If any errors are discovered, the auditor is to take *immediate* corrective action including:

- Obtaining the date when the change or error first occurred.
- Notifying ~~district~~ District ~~compliance~~ Compliance as described in section 0219.03 (or preparing other forms as required by District Compliance) if an area code change is required.
- Notifying District Compliance of new or closed-out subpermits.

The appropriate BOE-80 series "Audit Engagement Letter" should be used to confirm arrangements to begin audits or to establish contact with the taxpayer.

Normally the initial contact with the taxpayer will be by telephone. When the audit appointment results from a telephone contact, the appointment must be immediately confirmed by mailing the BOE-80-A, "Confirm Start Date" letter together with Pamphlet No. 70, "The California Taxpayers' Bill Of Rights," Pamphlet No. 76, "Audits,"

and Pamphlet No. 17, "Appeals" unless the audit will commence within a week of making the appointment.

## **DISCUSSION WITH TAXPAYER**

**0403.4512**

When the auditor arrives at the taxpayer's place of business at the appointed time, ~~they~~ the auditor should have a preliminary discussion with the taxpayer or with the person who has charge of the records before starting the audit work. A representative tax return should be examined, and the taxpayer should be requested to point out the source of the figures used to compile the return. **A discussion about how the ledgers and summary records are maintained is imperative at this time.**

The auditor should determine, by direct questioning of the taxpayer, the exact nature of the business activity for the audit period. Inquiry should be made about changes in key clerks, accountants and/or accounting systems, as variations in the type of business, or in the methods of conducting business will have an effect on the approach to making an audit.

## **CONTACTS WITH THIRD PARTY REPRESENTATIVES**

**0403.4714**

In order to protect the taxpayer, it is imperative that before any discussion or correspondence is initiated with a person claiming to be a representative of the taxpayer, the auditor secures written authorization from the taxpayer. It is not generally necessary to obtain this authorization when the taxpayer introduces or refers the auditor to their representative. It is also not necessary to obtain an authorization when the representative is a professional governed by a code of ethics, e.g., a certified public accountant or attorney. However, it is a good practice when contacted unilaterally by a professional to acknowledge the contact in writing with a copy to the taxpayer. ~~The taxpayer~~ Taxpayers should receive copies of all correspondence between the Board and their representative concerning their case(s).

## **LIMITATIONS ON CONTACTS WITH TAXPAYERS REPRESENTED BY COUNSEL**

**0403.16**

Board employees who are not attorneys are not required to refrain from contacting or speaking with taxpayers who are represented by legal counsel, a CPA, or other representatives, even in those instances where the representative has requested that the employees do refrain. Disregarding a representative's request should be done only after consulting with the employee's supervisor and be based, in part, on the representative's degree of cooperation with Board staff and the fact that the taxpayer does not timely comply with the Board action requested through the representative.

If the taxpayer or his or her representative has requested that no contact with the taxpayer be made without the taxpayer's representative present, the auditor should notify his or her direct supervisor and fully document the request on Form BOE-414-Z. In addition, all subsequent contacts with the taxpayer should be documented on the BOE-414-Z to protect against potential claims or allegations of harassment. A supervisor or lead person may also accompany the employee for difficult negotiations.

If the taxpayer or his or her attorney has obtained a restraining order forbidding contact by the Board without the attorney present, the Board employee must comply with the order. In such cases, the Chief, of Field Operations Division or the Chief, Collections and Third District Operations ~~Manager~~ Division, Internal Security and Audit Division, and the Chief Counsel should be notified of the order for appropriate action.

## AUDIT PROGRAM

0404.10

All audits must be guided by an organized plan. A carefully thought-out, but flexible, overall plan (audit program) is the first step towards good working papers and a good start. Such a plan forces advance thinking and a proper overview of the assignment as a whole. As such, audit programs are **mandatory** and must be completed for all audit assignments. Audit programs must be written on a separate schedule and included as a memo in the audit. Much of the information needed to prepare the audit program can be obtained from the BOE-472, Audit Sampling Plan. See Exhibit 11 for sample audit programs for general retailers, manufacturers and wholesalers, and liquor stores. These sample programs may be used as a guideline in developing a program for your audit.

Audit programs are influenced by the results of the preliminary investigation, surface examination of the records, and limited testing procedures. As such, audit programs need to be flexible and are subject to change as circumstances warrant.

~~If many errors are found in any test, it should be expanded so that a good base for calculating a percentage of error will be available. On the other hand, if no errors are developed in the first period tested, if the records are in good condition, and if the personnel are well informed on the correct application of the tax, often times the testing may be terminated with one period. The auditor must use their judgment based on observations of the records, plant and personnel to decide just how much verification is required.~~

## USE OF FORM BOE-472, AUDIT SAMPLING PLAN

0405.23

In an effort to document the sampling method used in an audit, the Board has developed Form BOE-472 — Audit Sampling Plan. (See Exhibit 5) Its purpose is to establish the most efficient means of developing a sampling plan and document: (1) the sampling method that will be used to determine a percentage of error in the population being tested and (2) the projection of the sample results.

The purpose of the BOE-472 is to establish the most effective and efficient means of developing a sampling plan. *This form must be used in all large audits (defined here as any audit with a cell designation of 1D through 4D) or any time sampling is performed.* This plan will provide much of the information that will later be needed to complete the working paper documentation and audit comments.

Prior to determining the type of testing to be used in a given audit situation, the auditor must make a thorough examination of the business operation for the period under audit. This examination should include a review of source documents, changes in business activity, and changes in accounting procedures and key personnel. Once this information has been evaluated, a determination of the best method of testing can be made. Form BOE-472 will assist the auditor and taxpayer in identifying crucial elements of the audit sampling plan. This form is to be used as a tool to gather information in conducting samples, as well as to educate taxpayers about the sampling process and make the taxpayer aware of important considerations that might impact the audit. This form also identifies special situations that might arise during a test and allows both the taxpayer and auditor to agree on how to handle them. It should be completed with assistance and input from the taxpayer, prior to the actual selection of the sample, and used in conjunction with information and guidelines provided in the appropriate sections of the Audit Manual.

The information and methods documented in this form are not binding on either the taxpayer or Board staff. The sampling plan can and should be continually evaluated (and changed, if necessary) based upon information obtained during the audit process. However, if any deviation from this sampling plan is required, the deviations will be fully explained and discussed with the taxpayer.

While BOE-472 includes many situations that might arise in sampling, it cannot include them all. As such, the form should be modified (in Section 11, "Other") to address any situations not included in previous sections of the form. Once the information has been evaluated, the auditor is in a position to determine the best method of testing.

This form is to be included in the audit working papers as a ~~memo~~-subsidiary schedule. A separate plan should be completed for each area tested. For example, if the audit includes a sample test of both paid bills and resales, two BOE-472s should be completed. (Exhibit 5)

## **OBTAINING FINANCIAL INFORMATION**

**0405.27**

Board staff must first try to obtain from the taxpayer any data or documents which should have been retained in accordance with Revenue and Taxation Code section 7053. However, if all other available avenues of information have been exhausted and approval of the district administrator has been obtained, Board staff may request the information directly from the taxpayer's financial institution either by obtaining the taxpayer's authorization or by issuing a subpoena duces tecum.

Procedures for requesting records directly from a financial institution, including procedures to comply with the California Right to Financial Privacy Act, are explained in detail in CPPM sections 135.070 through 135.073.

## USE OF PRIOR AUDIT PERCENTAGES OF ERROR IN CURRENT AUDITS

(CONT.) 0405.33

If stratified dollar limitations were used in the last two audits, generally the same dollar stratification should be used in the current audit. However, if there is an indication during the limited testing that a different stratification level may be appropriate in the current audit, the new stratification level should be used. If so, the prior percentages of error will have to be adjusted to reflect the new stratification level.

For example, a decrease or increase in the stratification level will affect the sample base (by deleting or including sample items), the population base (by deleting or including population items) and the percentage of error (by deleting or including error items) in prior audits. These recalculations must be made so that the proposed percentage of error to be used in the current audit is an accurate representation of the prior audit percentages of error at the new stratification level.

This information should then be used by the District Principal Auditor and audit supervisor to evaluate such taxpayers for inclusion in this program.

Those taxpayers meeting the criteria described above should then be contacted and the program explained to them by an auditor and audit supervisor. The taxpayer ~~should~~must also be informed that this procedure will not be used in consecutive audits.

After the discussion with eligible taxpayers, a detailed outline (Exhibit 6) should be prepared for each interested taxpayer indicating why they would make a good candidate for inclusion in this program. Each outline should include:

- (a) Name and account number of the eligible taxpayer
- (b) Nature of taxpayer's business
- (c) Current audit period
- (d) Portion(s) of audit where a prior percentage of error is to be used
- (e) Prior audit periods and corresponding percentages of error for those portion(s)
- (f) Population(s) to which the prior percentage(s) of error was applied
- (g) Proposed percentage of error to be used for the portion(s) in the current audit
- (h) Population(s) to which the proposed percentage(s) of error will be applied in the current audit
- (i) Any other pertinent information

This outline should then be sent by the District Principal Auditor to the Program Planning Chief, Tax Policy Manager Division (with a "cc" to the Chief, of Field Operations Division or the Chief, Collections and Third District Operations Manager Division) for review and evaluation (Exhibit 6, page 1). The district will be notified of the decision regarding the review and evaluation. Upon completion of the audit, the district will prepare an evaluation memo (Exhibit 6, page 2) to the Chief Program Planning Tax Policy Manager Division (with a "cc" to the Chief, of Field Operations Division or the Chief, Collections and Third District Operations Manager Division), detailing the **tax change** of that portion(s) of the audit utilizing the prior percentage of error along with an estimate of the number of audit hours saved. A copy of the evaluation and authorization memos should be included as memo schedules in the audit working papers.

## CONCESSIONAIRES

0406.60

For sales and use tax purposes, concessionaires are independent retailers who are authorized, through contract with, or permission of, another retail business enterprise (the prime retailer), to operate within the perimeter of the prime retailer's own retail business premises. Concessionaires appear to be wholly under the control of the prime retailer, and to make retail sales that to the general public might reasonably be believed to be the transactions of the prime retailer. ~~Certain departments are leased to others under contracts which take various forms but the~~ The usual bases for payment of store occupancy to the ~~lessor~~ prime retailer are:

- (a) Percentage of net or gross sales with possible provision for minimum rental payment
- (b) A fixed rental
- (c) A profit-sharing arrangement

The prime retailer's general ledger should contain a clearing account for concessionaire operations. ~~The store has sales tax liability for the operations of lessees who are not registered with the Board for the period of operation. The prime retailer may be held jointly and severally liable for sales and use taxes imposed on unreported retail sales by the concessionaire while operating as a concessionaire. The prime retailer will be relieved of this liability for the period in which the concessionaire holds a permit for the location of the prime retailer, or the prime retailer has a written statement (as provided in Regulation 1699) taken in good faith in which the concessionaire affirms that he or she holds a seller's permit for the prime retailer's location~~(Regulation 1699).

If ~~there are~~ the prime retailer has concessionaires, the auditor should secure a complete list of all leased departments operated during the audit period, showing the department's ~~concessionaire's name, and number, address of operator, phone number, and the sales tax~~ seller's permit number, if any, ~~held by lessee~~. Even though ~~when the department store~~ prime retailer does report the concessionaires' sales transactions, special attention should be given to the possible liability for use tax of the concessionaire for operating supplies, giveaways, etc., since these are often shipped into ~~the State~~ California from the concessionaires' out-of-state home office or purchased from out-of-state retailers.

## EXAMINATION OF SELECTED GENERAL LEDGER ACCOUNTS

0408.25

The verification procedure should include an examination of debits in certain general ledger accounts. This is necessary as invoices covering capital expenditures frequently are not filed with the other purchase invoices. From the documentary reference, it is possible to trace the originating documents. Taxable purchases not previously scheduled on which tax was not added by the vendor, should be scheduled and verification made that the taxpayer is responsible for tax. These items are generally located in the following accounts:

Asset Accounts	Expense Accounts
Delivery Equipment	Advertising
Furniture and Fixtures	Donations
Inter-Company Accounts	Expendable Tools
Leasehold Improvements	Experimental and Exploration
Machinery and Equipment	Manufacturing Expense
Nonexpendable Tools	Repairs
Work in Progress	Research and Development
	Supplies
	Samples
	Promotional

This phase of the examination can be done at the same time these accounts are being examined for additional taxable sales.

The auditor should examine invoices representing purchases of significant taxable additions to fixed asset accounts.

Unsupported debits to the fixed asset accounts should be questioned by the auditor and listed on a subsidiary schedule. The taxpayer should be provided with a copy of this schedule and given a reasonable period of time to obtain support for the items in question before closing the audit. If no support is provided, use tax should be asserted against the taxpayer. When necessary, a Waiver of Limitation, Form BOE-122, should be obtained.

The examination of asset accounts may reveal that the proper amount of use tax has not been paid to the Department of Motor Vehicles on the purchase price of a vehicle. Generally, this occurs in those instances in which (1) the change in ownership was not recorded with the Department of Motor Vehicles; (2) the selling price was substantially different than the measure on which tax was collected by the Department of Motor Vehicles; or (3) the vehicle has special equipment attached which was not included in the measure on which tax was collected by the Department of Motor Vehicles.

In such instances, the use tax is to be asserted against the purchaser. (See the tables in CPPM 830.005 for specific examples of how penalty and interest may apply to use tax due on purchases of vehicles.)

The measure of additional tax is not to be included in Form BOE-414-A, Report of Field Audit, on the seller, even ~~though~~ when disclosed by audit of the seller.

In recommending the additional measure against the purchaser, either Form BOE-414-A, Report of Field Audit, or Form BOE-414-B, Field Billing Order, will be used, depending on the extent of the examination of the purchaser's records.

Form BOE-111, Certificate of Vehicle, Mobilehome or Commercial Coach Use Tax Clearance, will be issued by the district office for those vehicles on which tax is recommended by audit or F.B.O. and the change in ownership was not recorded with the Department of Motor Vehicles.

**OTHER RECORDS****0408.27**

Other records may be useful in establishing purchases subject to use tax including property tax records such as the Business Property Statement that taxpayers are required to file with their county assessor's office on an annual basis. The statement lists all equipment the taxpayer uses in his or her business along with the purchase price and acquisition date.

## USE OF BOE-504 — XYZ LETTER PROCEDURE

0409.51

The auditor must ~~insure~~ensure that the taxpayer understands that any of the above other evidence by itself is not the equivalent of a resale certificate timely taken in good faith, and may not relieve the seller of the liability for the tax.

In absence of any valid resale documentation, the auditor may determine that it is appropriate for a seller to use the Form BOE-504 series of forms (hereafter called "XYZ" Letters) procedure to help satisfy their burden of proving that a sale was not at retail even though a valid resale certificate was not obtained or to substantiate a claim that their customer paid the tax directly to the state. Copies of the forms are available on eBOE.

The "XYZ" Letter procedure utilizes the following forms:

- BOE-504-A, explains the "XYZ" Letter procedure
- BOE-504-B, Sample "XYZ" Cover Letter
- BOE-504-C, Statement Concerning Property Purchased Without Payment of California Sales Tax, for use when auditing in-state sellers
- BOE-504-COS, for use when auditing out-of-state sellers \*
- BOE-504-CLS, for use when questioning sales made to leasing companies \*
- BOE-504-BPA and BOE-504-CPA, for use when questioning ex-tax sales of special printing aids (also see AM section 1103.30) \*
- BOE-504-CFS, for use when questioning ex-tax sales of feed, fertilizer, seed or annual plants—\*
- BOE-504-CUS, for use when questioning ex-tax sales made to U.S. Government supply contractors \*

*\*— These forms are "PC" forms and are available on disk only. The disk is available in each district office and should be printed out as needed.*

When it is appropriate to use the "XYZ" Letter process, the auditor will provide the taxpayer with a copy of forms BOE-504-A, B, and C (or -COS, -CLS, -CPA, -CFS or -CUS as appropriate). The auditor should discuss the "XYZ" Letter process with the taxpayer and explain that a ~~satisfactory~~ response to an "XYZ" Letter inquiry alone is not necessarily enough to support a sale for resale. The auditor should also explain that since the "XYZ" Letter is not a substitute for a timely resale certificate, additional documentation or information may be required. Where the use of "XYZ" Letters is not advisable or appropriate, and the taxpayer insists on using the procedure, the taxpayer must be advised in writing that their customer's response may not be accepted as verification of an exempt transaction.

A period of four weeks will be allowed for the taxpayer to prepare and send the "XYZ" statements and for the customer to reply. It is recommended that the "XYZ" statements be returned directly to the Board. If this is the case, the auditor should provide the taxpayer with return envelopes with the address of his or her district branch office. If the taxpayer elects to have the "XYZ" statements returned to them, the auditor should explain to the taxpayer that the likelihood of having staff contact the customer or sending an additional mailing is greater.

The taxpayer may customize the "XYZ" cover letter (BOE-504-B or BOE-504-BPA for special printing aids) by using the text contained therein on their own letterhead—;

however, the text in the sample letter should be used without additions, deletions, or changes. The taxpayer may ask their customers to forward payment of tax reimbursement if the transaction is identified as taxable. The statement should clearly state that the payment of tax be forwarded to the taxpayer and not the Board. All modifications to the cover letter must be approved by the auditor's supervisor.

The "XYZ" statement (BOE-504-C, COS, CLS, CPA, CFS, or CUS) must be used as provided by

the auditor. The use of a standardized "XYZ" statement will reduce any possible controversy over whether the proof provided is satisfactory. When verifying unique types of sales (e.g. printing aids, animal feed, fertilizer, etc.), auditor should provide the specialized forms to the taxpayer. The auditor should put his or her office designation in the space marked "DMA" and their initials in the space marked "Auditor's Initials," both located at the top right of the "XYZ" statements.

The taxpayer's customer is requested to return the completed "XYZ" statement within 10 days. The 10-day requirement is intended to encourage a prompt response from the customer. If the taxpayer chooses the recommended procedure of having the completed "XYZ" statements sent directly to the Board, the taxpayer may add a statement in the letter (BOE-504-B) asking their customer to send a copy of the completed "XYZ" statement to them by fax or mail. The original "XYZ" statement, however, must either be sent or faxed to the Board by the taxpayer's customer. If the completed "XYZ" statements are to be sent directly to the taxpayer, only a signed original will be accepted.

If a second "XYZ" Letter is necessary, the auditor should establish a reasonable period of time based on the circumstances involved.

As explained in section 0302.80, XYZ responses are part of the audit working papers and should be included as a subsidiary schedule to the resale examination schedule.

## **TAX ASSESSED ON PURCHASER**

**0409.63**

Whenever a purchase from a California seller is assessed tax because the purchaser issued a resale certificate to the seller, which the seller accepted in good faith, a copy of this certificate should be obtained from the seller at the time of audit and included in the audit working papers of the purchaser's audit. When contacting the seller, the auditor may not inform the seller that the auditor is reviewing the purchaser's records. Instead, the auditor is only allowed to inform the seller that he or she is only verifying whether the seller has a copy of the purchaser's resale certificate on file, and if so, to request a copy of the certificate.

Because the issuance of a resale certificate shifts the tax from the seller to the customer/purchaser, it is imperative that a copy of the resale certificate be obtained while the auditor is reviewing the seller/purchaser's records. A verbal comment by the purchaser that a resale certificate was given to the seller is insufficient. Often customers will indicate concurrence when the audit is completed but change their mind when the Notice of Determination is received and contend that no such certificate was issued and the incidence of tax should be on the California seller. Without written evidence to refute this claim, the Board's position cannot be sustained.

## **AUDITING PROCEDURE 0410.10**

An audit of this deduction should be made in the same manner as an audit of a deduction for sales for resale. Ordinarily the number of such sales is limited and the audit should be made on a complete basis. If, however, the number of items claimed is exceptionally large and the average unit of sale is comparatively small, a test basis may be used. Documentary evidence required to support the deduction, where the sale is made directly to the United States Government, a subdivision or agent, should consist of one or more of the following documents:

- Purchase orders
- ~~Remittance advices~~
- Copy of U.S. Government credit card or credit card number
- Other documents demonstrating direct payment by the United States
- Shipping and other documents if there is a question whether the merchandise was sold directly to an individual who is in the armed services

In the absence of documentation to support claimed sales to the U.S. Government, the auditor may determine that it is appropriate for a seller to use the BOE-504 series of forms (BOE-504-CUS) procedure to help satisfy their burden of proving that a sale was not at retail even though exempt documentation was not obtained (§see section 0409.51 for procedures).

Sales to contractors who are engaged in work on projects owned by the United States Government are not sales to the Government. If the contractor is actually selling tangible personal property to the U.S. Government, such sales are sales for resale and should be verified as such. Mention is made of this in this section only because many retailers classify such sales as sales to the United States Government and erroneously claim the deduction under that heading rather than sales for resale. If the auditor has reason to believe the material purchased was not actually sold by the contractor-customer to the U.S. Government, a Form BOE-1164, Audit Memorandum of Possible Tax Liability (see section 0401.20), should be prepared setting forth all pertinent phases of the transaction.

## **SALES TO FEDERAL EMPLOYEES USING U.S. GOVERNMENT BANKCARDS 0410.15**

The federal government issues credit cards to its employees for purchases of goods and services. Beginning November 30, 1998, the purchases are under a new program called "GSA SmartPay" and is effective for ~~5 years~~ through November 28, 2008. Cards will now be issued by Citibank, First National Bank of Chicago, NationsBank, Mellon Bank, and U.S. Bank. The new cards bear 16-digit account numbers with unique prefixes, government designed artwork, and are imprinted with "United States of America" at the top. In the right-hand corner, cards contain a logo which says "SmartPay." The cards also bear wording that denotes the card is for "Official Government Use Only." The General Services Administration administers the program for all departments and agencies of the U.S. Government.

Purchases made with most of the new cards are directly billed to the government and will represent nontaxable sales to the U.S. Government. Those purchases directly billed to the employee are subject to sales tax. To determine which government credit cards are government-billed and which are employee-billed, retailers will have to consider the type of card, the type of transaction, and the card account numbers. Generally, through use of the Bankcard System and coding authorization, purchases are automatically denied if a particular type of card is used to make a type of purchase for which that card was not issued.

For **FLEET CARDS**, there are two types of U.S. Government "fleet" cards which may be issued to federal employees to make fleet type purchases (e.g., gasoline, oil, etc.). One is a Voyager card and the other is a MasterCard. They Voyager cards contain 16-digit account numbers that start with the prefix 8699. The MasterCard cards contains 16-digit account numbers that start with the prefix 5568. All fleet type purchases made with these cards are billed directly to the U.S. Government and are not taxable.

For **PURCHASE CARDS**, there are two types of U.S. Government "purchase" cards which may be issued to federal employees to make purchases of goods (e.g., office supplies, parts, etc.). One is a VISA card and the other is a MasterCard. The Visa cards contains 16-digit account numbers that start with the prefix 4486 or 4716. The MasterCard cards contain 16-digit account numbers that start with the prefix 5568. All purchases of goods made with these cards are billed directly to the U.S. Government and are not taxable.

For **TRAVEL CARDS**, there are two types of U.S. Government "travel" credit cards which may be used by federal employees to make travel type purchases (e.g., hotels, car rentals, restaurants, etc.). One is a VISA card and the other is a MasterCard. The Visa cards contains 16-digit account numbers that start with the prefix 4486 or 4716. The MasterCard cards contain 16-digit account numbers that start with the prefix 5568. Federal government travel cards may either be billed to the U.S. Government or to the federal employee depending upon the account number. If purchases made with travel cards are billed to the employee, the sales are subject to tax. To determine whether purchases made with federal government travel cards are government-billed or employee-billed, retailers must look at the 6<sup>th</sup> digit of the account number of the card. If the 6<sup>th</sup> digit is 1, 2, 3, or 4, purchases are billed to the employee and are taxable. If the 6<sup>th</sup> digit is 0, 6, 7, 8, or 9, purchases are billed to the U.S. Government and are not taxable. This procedure applies to both VISA and MasterCard travel cards.

In some instances, some federal agencies will issue **INTEGRATED CARDS** for the

purpose of “fleet,” “property,” and “travel” purchases. These cards are provided by MasterCard and contain a 16-digit account number that starts with 5568-16. All fleet and property purchases made with these cards are billed directly to the U.S. Government and are not taxable. However, travel purchases may be either government-billed or employee-billed depending upon the account number. To determine whether travel purchases are government-billed or employee-billed, retailers must again look at the 6<sup>th</sup> digit of the account number of the card. If the 6<sup>th</sup> digit is 1, 2, 3, or 4, purchases are billed to the employee and are taxable. If the 6<sup>th</sup> digit is 0, 6, 7, 8, or 9, purchases are billed to the U.S. Government and are not taxable.

*Exception: All purchases made with integrated MasterCard credit cards provided by the Bureau of Reclamation employees, including travel purchases, are billed directly to the U.S. Government and are thus exempt from tax. Bureau of Reclamation employees will have to identify themselves to the retailer and show proof of Bureau employment to obtain the exemption.*

Retailers who make U.S. Government credit card sales should retain the credit card receipt containing the imprint of the credit card and the sales invoice to support exempt transactions to the U.S. Government. If the purchase is by telephone, the retailer should note the credit card account number and purchaser’s name on the credit card receipt.

## LEASES

0411.25

In general, a lease of tangible personal property to a United States contractor is subject to tax whether or not such contractor is properly authorized to act as a purchasing agent of the United States. However, leases are exempt when they are (1) to contractors that occupy the legal status of agents of the United States and (2) to non-agent cost-plus federal contractors, other than Department of Defense contractors, that act as agents when procuring from General Services Administration ("GSA") Supply Sources ("FSS" or "ADPS") pursuant to a letter of authorization issued by a federal contracting officer which has language creating an agency relationship.

It has been the policy of the Department of Defense not to designate government contractors as legal agents of the United States. Therefore, a lease between a Department of Defense contractor and a vendor would not include the United States as a party to such lease, notwithstanding any FAR provision which attempts to characterize the buyer-lessee as an agent for the Department of Defense. Consequently, lease payments made by a Department of Defense contractor, which are charged as direct consumable supplies to a fixed price contract or cost reimbursement contract are subject to the sales or use tax.

Should a Department of Defense contractor nevertheless claim agency relationship with respect to a lease, the contractor should be requested to provide documentation to support such claim. The documentation should be submitted to the Program Planning Chief, Tax Policy Manager Division (with a "cc" to the Chief, of Field Operations Division or the Chief, Collections and Third District Operations Manager Division) for communication with the Secretary of Defense to ascertain the Department's position with respect to the specific contract.

## CERTIFICATE OF VERIFICATION — OUT-OF-STATE DELIVERY

0414.12

A period of four weeks will normally be sufficient for the taxpayer to prepare and send the certificate and for a reply to be received. The taxpayer should prepare the certificate to be completed in triplicate. It is recommended that the certificate be returned directly to the Board. If this is the case, the auditor should provide the taxpayer with return envelopes with the address of his or her district or branch office. Please note, business reply envelopes (no postage necessary) should not be used.

The taxpayer may customize the cover letter, Form BOE-52-L, by using the text contained therein on their own letterhead; however, the text in the sample letter should be used without additions, deletions or changes. Any modifications to the cover letter must be approved by the auditor's supervisor.

The taxpayer's customer is asked to return the completed certificate within 10 days. The 10-day requirement is intended to encourage a prompt response from the customer. If the taxpayer chooses the recommended procedure of having the completed certificate returned directly to the Board, the taxpayer may add a request to the cover letter asking its customer to also send a copy of the completed certificate to the taxpayer. The taxpayer's customer should send the originally signed and completed certificate to the Board (may be sent by facsimile). However, if the taxpayer's customer sends the certificate directly to the taxpayer and then the taxpayer sends the certificate to the Board, the Board will accept only the originally signed and completed certificate and will not accept a facsimile copy. If a second certificate is necessary for verification, the auditor should establish a reasonable period of time for completion based on the circumstances involved.

### **Use of Form BOE-52 by Audit Staff**

When the auditor has good reason to believe that merchandise was not shipped as specified by the shipping documents, or that empty boxes may have been shipped to purchasers as a means to support the interstate commerce exemption, it may be appropriate to use Form BOE-52 as a verification method for receipt of out-of-state shipments. In addition to the certificate, Form BOE-52-L1 (Exhibit 14B) provides a suggested cover letter for use by the districts in explaining the purpose of the certificate and requesting the purchaser's statement regarding receipt of the item and place of delivery. The decision to use this verification method should be based on the materiality of the questioned transaction(s) and on the surrounding circumstances. The auditor should prepare the certificate to be completed in triplicate. Postage-paid return envelopes may be included in the mailing to increase the likelihood of response for this case in which the Board is seeking verification of shipment without seller involvement.

### **Returned Form BOE-52s**

As explained above, the seller, or the auditor when the seller is not involved, should prepare the certificate to be completed in triplicate. The original certificate should be included in the audit working papers. If out-of-state delivery is indicated, to Arizona, Mexico, New Mexico, Oklahoma, Texas, or Utah, or country of Mexico, a copy should be sent to the attention of the Revenue Opportunity Specialist in the Audit Support Unit (MIC: 44). For all other areas, a copy should be sent to the taxing authority in the state of the purchaser, for example the Department of Revenue of that state. The final copy should be given to the seller for their records.

## REFUNDS OF EXCESS TAX REIMBURSEMENT

0417.07

Regulation 1700 provides that refunds of amounts of excess tax reimbursement paid to the Board as sales tax may be refunded to the retailer upon submission of "evidence sufficient to establish that excess amounts have been or will be returned to the customer."

This has been construed to mean that the retailer must actually refund amounts collected as excess tax reimbursement to their customers rather than give a credit unless they can show one of the following:

- The customer agrees to a credit.
- The customer's debt to the retailer is acknowledged by the customer or made certain by a court proceeding.
- The amounts to be credited are small and apply to numerous customers.

The retailer should maintain records as provided in Regulation 1700(b)(3) as evidence that the excess amounts have been or will be returned to the customer.

**No refund of excess tax reimbursement is allowable without acknowledgement from customers.** The BOE-52-L2, Notice of Pending Refund of Excess Sales Tax Reimbursement, (Exhibit 14C) is available to assist the retailer in obtaining sufficient evidence from customers to establish the excess tax amount reimbursements have been or will be returned. The retailer can simply complete the BOE-52-L2 letter for each customer affected and retain the customers' signed responses. The notice informs the customer of the amount of indebtedness in writing and provides a check box for the customer to indicate their preference of a refund or credit to their account for the amount of excess sales tax paid. The retailer must obtain and maintain the signed acknowledgement in their records as proof of the refund or credit being given.

Taxpayers are not required to use this form, however any other type of acknowledgement must satisfy all of the requirements under Regulation 1700 (b)(3)(B). It is not necessary to include copies of the signed acknowledgements in the audit working papers, however verification comments should include complete comments or statements regarding the examination of the acknowledgements and their retention by the taxpayer. Form BOE-52-L2 is available on eBOE.

~~In order to assure that such excessive reimbursement will, in fact, be returned or credited under the above circumstances to the customer, it is suggested that prior to recommending to refund in an audit, a letter similar to the following be obtained from the taxpayer:~~

~~In order to qualify for consideration of refund of excess sales and use tax reimbursement collected by me during the period \_\_\_\_\_, the undersigned seller, hereinafter referred to as seller, agrees to do the following:~~

- ~~• Notify in writing each person from whom excessive tax reimbursement was collected the amount of tax that will be returned if and when the Board of Equalization refunds the tax to the seller.~~
- ~~• Provide an affidavit listing the persons to whom such notices were mailed or delivered and the amounts involved.~~
- ~~• Return the excessive tax reimbursement to the customers, or credit~~

~~the customers' accounts under conditions prescribed by the Board of Equalization.~~

~~I understand that failure to return the tax to the customer, or validly credit their account, within 30 days from the date received by the seller will subject the seller to appropriate action for recovery of the tax plus appropriate penalties.~~

~~Seller \_\_\_\_\_~~

~~By \_\_\_\_\_~~

~~Title \_\_\_\_\_~~

~~Permit No. \_\_\_\_\_~~

~~Address \_\_\_\_\_~~

~~\_\_\_\_\_~~

~~\_\_\_\_\_~~

**Bad Debts Incurred by Lessors**

- A bad debt deduction is allowable on reported taxable rental receipts which are found to be worthless and charged off for income tax purposes.
- On leases or renewals of leases, the lessor is required to collect use tax from the lessee at the time rentals are paid by the lessee and to pay the tax during the corresponding reporting period. If the lessor has computed and paid tax to the state on lease payments that were due but not paid by the lessee, then the lessor has made a tax overpayment subject to refund or credit. Therefore, the taxpayer may claim a refund without having to write off the account as a bad debt for income tax purposes. If however, the account was properly written off and claimed as a bad debt deduction, it should be allowed.
- When leases of tangible personal property situated in this State are not subject to use tax because of the exempt status of the lessee (e.g. insurance companies), the lessor nevertheless is subject to sales tax measured by the rental receipts. Therefore, taxes are due from the lessor on the basis of rentals payable and not rentals paid, and a valid bad debt deduction may result for sales tax purposes.

**Bad Debt Deductions to Persons Other Than the Retailer**

- A successor who pays full consideration for receivables acquired from their predecessor is entitled to a bad debt deduction to the same extent that the predecessor would have been had they continued the business.
- ~~• A purchaser of receivables, other than a successor, cannot obtain a bad debt deduction on accounts that cannot be collected.~~
- A retailer who sells receivables at a discount cannot obtain a bad debt deduction for the amount of the discount.
- See section 0419.17 for audit procedures on bad debt deductions claimed by lenders on purchased receivables.

**Bad Debts of Construction Contractors**

- When under a time and material contract a contractor bills their customer for tax reimbursement computed upon a marked-up price for materials, pays the tax accordingly and the receivable is thereafter found to be worthless and charged off for income tax purposes, or if the contractor is not required to file income tax returns, charged off in accordance with generally accepted accounting principles, a bad debt deduction may be taken by the contractor for the total amount. The contractor is a retailer in this situation.
- Since a contractor is the retailer of fixtures (other than those used in performance of contracts with the United States) bad debt losses incurred in connection with the furnishing and installing of fixtures are to be treated in the same manner as those resulting from other types of retail sales.

## **BAD DEBTS INCURRED BY LENDERS ON PURCHASED ACCOUNTS RECEIVABLE**

**0419.17**

### **General**

An account receivable (“account”) may be sold with or without recourse. “With recourse” means the retailer must reimburse the purchaser of the account (“lender”) for any losses the lender suffers. “Without recourse” means the retailer has no obligation to reimburse the lender even if the lender cannot recover the full amount of the debt.

**Accounts sold with recourse:** A lender who purchases an account with recourse may not take a bad debt deduction under the Sales and Use Tax Law with respect to any loss it suffers on that account (i.e., uncollectible debt for which it fails to obtain reimbursement from the retailer). However, a retailer who sells an account with recourse may take a bad debt deduction for the amount of uncollectible debt for which the retailer actually reimburses the lender pursuant to their contract, to the extent that such loss represents amounts on which the retailer reported and paid tax. These rules remain the law, and have not been affected by the provisions of Regulation 1642(h)(3) and (i).

**Accounts sold without recourse:** Regulation 1642(h)(3) and (i) apply to bad debt losses incurred on accounts created as a result of retail sales of tangible personal property for which the retailer remitted California sales or use tax on or after January 1, 2000. Transactions prior to January 1, 2000, may qualify for treatment under the Board’s memorandum opinion in WFS Financial, Inc. as discussed below.

### **Regulation 1642 subdivisions (h)(3) and (i)**

Auditors reviewing lenders’ claims for deduction or refund for which the retailer remitted California sales or use tax on or after January 1, 2000 should review Regulation 1642(h)(3) and (i). The subdivisions describe the conditions that must be met to claim a deduction or refund, the election agreement between the retailer and the lender, and election agreements between lenders and affiliated entities.

### **WFS Memorandum Opinion**

On December 14, 2000, the Board issued a memorandum opinion on a claim by a financial institution, WFS, for a refund for bad debts incurred from accounts purchased without recourse. The WFS Financial, Inc. opinion sets forth the requirements of when such transactions can qualify for bad debt deductions. The opinion can be found in the memorandum opinion section of the Business Taxes Law Guide.

The Legislature’s adoption of AB 599 (Stats. 2000, Ch. 600) superceded and replaced the WFS Financial, Inc. memorandum opinion. Revenue and Taxation Code sections 6055 and 6203.5, as amended by AB 599, are incorporated into and explained in Regulation 1642. The WFS decision applies through December 31, 1999, but not after the provisions of Regulation 1642(h)(3) and (i) became operative on January 1, 2000. Regulation 1642 (h)(3) and (i) generally apply to bad debts incurred in connection with transactions occurring during the 4th quarter 1999 since the taxes on those transactions were generally paid after January 1, 2000. However, the WFS decision itself applied to a claim for refund that included the 4th quarter 1999. Accordingly, to ensure fair and uniform treatment of all lenders and for administrative ease, a lender may rely on the provisions of either WFS or Regulation 1642(h)(3) and (i) for bad debts incurred in connection with transactions that occurred during the 4th quarter 1999. The provisions of WFS and Regulation 1642(h)(3) and (i) are otherwise mutually exclusive.

It is imperative to note that the determination of whether WFS or Regulation 1642(h)(3) and (i) applies is based on the date the taxes were remitted (usually ascertained based on the date at which the sale occurred), not the date the bad debts were incurred. For bad debts incurred in connection with sales of tangible personal property during the 3<sup>rd</sup> quarter 1999 and earlier, only the provisions of WFS apply and **not** the provisions of Regulation 1642(h)(3) and (i). Generally for bad debts incurred in connection with

sales of tangible personal property during the 1st quarter 2000 and later, only the provisions of Regulation 1642(h)(3) and (i) apply and **not** the provisions of WFS.<sup>1</sup>

Since the determination of whether WFS or Regulation 1642(h)(3) and (i) applies is based on the date tax was paid, but the timing of the bad debt deduction is based on the date the loss is written off, there will be claims submitted which include losses covered by both WFS and Regulation 1642(h)(3) and (i) which were written off in the same reporting period. For example, in the 2nd quarter 2002, a lender writes off two accounts as worthless, one for a sale that occurred in the 1st quarter 1999 and the other for a sale that occurred in the 1st quarter 2000. Tax had been paid for the first transaction prior to January 1, 2000, and the provisions of WFS apply to the loss from that account. Tax had been paid for the second transaction after January 1, 2000; therefore, provisions of Regulation 1642(h)(3) and (i) apply to that loss. Since the lender's right to claim the losses from these two accounts was established during the 2nd quarter of 2002, the deduction for both accounts should be taken on the lender's return for that reporting period. This means the statute of limitations for filing the lender's claim related to the losses on both accounts starts to run on July 31, 2002 (the due date of the return for the 2nd quarter 2002).

### **Indirect Loans**

If a consumer wishes to make a purchase on credit without using an existing credit account, the consumer may apply for a loan for that particular purchase. This is the method used for most purchases of automobiles, aircraft, and vessels, as well as many other large purchases, such as jewelry. The retailer may coordinate the loan application process, with the consumer signing a credit contract with the retailer who thereafter assigns the account to a lender. This type of loan is commonly called an "indirect loan" because the consumer does not contract directly with the lender who will service the loan, but rather contracts with the retailer. Since the retailer will then assign the account to the lender, bad debts from these accounts may qualify for deduction under Regulation 1642(h)(3) and (i).

### **Direct Loans**

Alternately, a consumer may arrange his or her own financing by contracting for a loan directly with a lender. This type of loan is commonly called a "direct loan" because the consumer contracts directly with the lender who will service the loan. In a direct loan situation, the consumer pays for his or her purchase with the proceeds from the loan (plus any down payment or other amounts paid out of the consumer's own funds). Methods of remitting the loan proceeds to the retailer include:

- a check issued by the lender in the retailer's name, which may be sent directly to the retailer or physically delivered by the consumer;
- a check issued in the names of both the retailer and the consumer which must be executed by both parties (and which may also be sent directly to the retailer or be physically delivered by the consumer, although the latter is more common because the consumer must also execute the check);
- and a direct electronic funds transfer from the lender to the account of the retailer.

The Board held in a separate case that bad debts incurred on certain direct loans are also eligible for deduction under WFS guidelines. In that case, although the purchaser contracted for financing directly with the lender, the lender worked closely with the dealer and remitted payment directly to the dealer. If instead the loan proceeds were to come into the full possession of the consumer (e.g., the consumer deposits the funds into the consumer's own account and then draws from that account to pay the purchase price), the loan would not qualify under WFS. Furthermore, for a direct loan to qualify under WFS, the dealer must receive payment in a manner that is essentially the same as for indirect loans that qualify

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Due to reporting requirements of 1642(h)(3) and (i), it is *theoretically* possible to have an annual basis retailer sell account receivables to a lender, which would make 1642(h)(3) and (i) apply to sales made for the entire year of 1999.

under WFS. While no specific time frame is required, this usually occurs within ten days of the date of sale. For example, when the loan is for the purchase of a vehicle, a qualifying direct loan would result in the lender's name being placed as lien holder on the ownership certificate as part of the initial registration of the vehicle in the consumer's name. Of course, the other conditions specified in WFS must also be satisfied.

The Board's decision that a lender making a direct loan might qualify for a bad debt deduction under WFS is also applicable to claims for bad debt deductions or refunds under Regulation 1642(h)(3) and (i). However, no deduction or refund is allowable unless and until the lender and the retailer who paid the tax file the election as explained in Regulation 1642(h)(3) and (i). Furthermore, Regulation 1642(h)(3) and (i) applies only when the lender has purchased the account directly from the retailer, or when the lender holds the account pursuant to the lender's contract directly with the retailer. Thus, even if a lender providing a direct loan can convince the retailer to sign an election agreement with the retailer, that does not automatically mean that the losses on the account will qualify for deduction or refund under Regulation 1642(h)(3) and (i). For Regulation 1642(h)(3) and (i) requirements with respect to a direct loan, a lender claiming a bad debt deduction or refund will be regarded as satisfying these conditions if the transaction would have qualified for deduction under WFS (as modified by the Board's ruling on direct loans).

For example, a consumer obtains a line of credit with a lender, perhaps secured by a second deed of trust on the consumer's home. The consumer then uses a check to access the line of credit to purchase a big-ticket item. The retailer receiving the check has no contact whatsoever with the lender except to deposit the check and obtain the funds. The lender and retailer thereafter enter into an election agreement. The loss on this account cannot qualify for deduction or refund under Regulation 1642(h)(3) and (i) since the lender cannot be regarded as having purchased the account from the retailer or holding the account pursuant to a contract with the retailer. On the other hand, a consumer applies for a loan from his or her credit union to purchase a vehicle. The consumer then purchases a vehicle under the normal vehicle sales contract giving him or her a stated number of days to pay the purchase price to the dealer. If the consumer does not make payment timely, the sales contract provides for the dealer to carry the loan (which the dealer could promptly assign to a lender, perhaps even the consumer's own credit union). During the completion of the paperwork and during the sale transaction process, the consumer provides information to the dealer regarding the credit union loan. The dealer contacts the credit union directly and after the necessary paperwork is completed, the credit union deposits the funds directly into the dealer's account. This direct loan will be regarded as satisfying the requirements that the lender purchased the account from the dealer, and if the other requirements of Regulation 1642(h)(3) and (i) are satisfied, the lender is eligible to claim a bad debt deduction or refund under Regulation 1642(h)(3) and (i).

### **Refinanced Loans**

When a loan is refinanced with the original lender, there are two situations where a deduction for bad debts incurred on the refinanced loan will be allowed provided all other requirements for a deduction are satisfied. One is when the refinancing is for the purpose of lowering the amount of the payment (through a reduced rate or extension of the term). The other is when the purpose of the refinancing is to obtain additional funds to pay for necessary repairs to the property purchased with the funds from the original loan, but only when the lender makes payment directly to the repair facility. When calculating the amount of the bad debt loss on qualified refinanced loans whose principal amount is increased to pay for repairs, the percentage of taxable loss must be reduced by the nontaxable portion of the repairs (in addition to the other adjustments for the nontaxable portion of the original loan). Losses incurred from refinanced loans through a different lender do not qualify for bad debt deductions, nor do losses from refinanced loans where the borrower withdrew any funds other than amounts paid by the lender directly to a repair facility for necessary repairs to the property originally financed.

## **Audit Procedures**

When reviewing claims for deduction or refund based on lender bad debts, the auditor should:

- Verify the accuracy of the claim for deduction or refund;
- Confirm the records provided adequately support the claim for deduction or refund;
- Ensure the records provided by the claimant are complete, as required by Regulation 1642(e);
- Confirm that the lender holds a Seller's Permit or a Certificate of Registration – Lender;
- Confirm that there is a valid election agreement on file specifying the claimant is the person entitled to claim the deduction or refund for that account; and
- Verify local and district tax deallocation from the jurisdiction that received the original local or district tax allocation.

For a lender to claim a bad debt deduction or refund, Regulation 1642(i)(2)(B) requires that “the account must have been found worthless and charged off by the lender for income tax purposes.” The standard practice of the lending/financial industry requires bad debts to be written off after a prescribed number of days regardless of any collection activity or payment arrangements made with the debtor, and without regard to whether the account is actually worthless. Thus, although accounts may be written off in accordance with industry standard practice, this does not necessarily mean they are worthless. For example, an account may be written off after the prescribed amount of time has passed, but the lender may have a payment plan in effect with a debtor. Although the account may be written off as a bad debt for other purposes, such an account would not generally be considered “worthless” for purposes of Regulation 1642 while the payment plan remains in effect.

Audit staff must include in the general comment section of the audit working papers a comment as to whether the claim for refund qualifies under WFS or Regulation 1642(h)(3) and (i). Both the lender's and retailer's accounts must be cross referenced, indicating the claim for refund, the basis of the claim (WFS or Regulation 1642(h)(3) and (i)), and the periods covered for each. The audit must include a review of the election agreement(s) to ensure each agreement is valid under Regulation 1642(h)(3)(A), (i)(3), or (i)(4)(A), as applicable, and pertains to the transactions under audit.

**Computing the Amount of the Bad Debt Loss:** A lender must provide a listing of all transactions (electronic or hard copy) for which it claims a bad debt deduction or refund, and must also be able to provide source documents for all such transactions. Transactions should be selected for review based on the auditor's discretion and not that of the lender. The amount of the bad debt for which the claim for deduction or refund is filed frequently includes some nontaxable elements (e.g., tax, license, earned or unearned interest, late fees, etc.). It would thus be highly unusual for a lender to be entitled to a bad debt deduction for the entire amount of its losses on an account. Rather, the lender must adjust the amount of its losses so its claimed deduction includes only the allowable taxable amounts. There are three basic methods of verifying the lender's claim for a bad debt deduction or refund: Actual Basis, Statistical Sampling and Mean Allowable.

Regardless of the method used, prior to beginning verification of the claim, all claimants should be informed that it might later be necessary to expand the size of the sample to ensure a representative sample is taken so the accuracy of the claim is assured. A claimant must be able and willing to provide documentation to support all transactions included in the claim, regardless of accessibility. Transactions for which the claimant is not capable and willing to provide supporting documentation must be disallowed, even in cases where the claimant purports to have documentation but cannot provide copies because they are not readily accessible.

1. **Actual Basis:** The lender provides a listing of accounts on an actual basis and computes the amount of the allowable bad debt loss on each account on a transaction-by-transaction basis. The information included in the listing must include the items in Appendix 2 of the regulation. Under this method, the lender computes the claimed bad debt loss for sales and use tax purposes on an actual basis and staff is verifying the accuracy of the lender's listing. Staff should utilize statistical sampling techniques to verify the accuracy of the lender's claimed refund. Staff must follow the guidelines for performing a statistical sample set forth in Audit Manual Chapter 13.

When statistical sampling is used staff must select a sample size of no fewer than 300 transactions. If the population is less than 300, the transactions should be examined on an actual basis. The auditor may discover no material discrepancies after testing a sufficient portion of the sample that the auditor is comfortable in concluding the amount of bad debt loss claimed by the taxpayer is correct. If so, the auditor, in his or her discretion, may terminate the test and accept the amount of bad debt loss claimed by the taxpayer. In reaching this conclusion prior to completing the test, the auditor must consider all factors relevant to the sample, the most important of which is the size and uniformity of the population. When the sample discloses material discrepancies among the lender's listing, the sample differences must be evaluated before projecting to the population. The Board's Statistical Sampling Evaluation program will be used to evaluate the differences. If the sample evaluates well, a percentage of error should be computed and applied to the population of transactions included on the lender's listing to determine the allowable refund amount. If the sample discloses discrepancies and does not evaluate well, staff should consider expanding the sample.

2. **Statistical Sampling:** The lender has provided a listing of the bad debt accounts written off per their books but they have not computed the allowable bad debt loss as described in Regulation 1642(d). The amount listed may include non-taxable elements such as tax, license, interest, late fees, repossession fees, etc. Staff must perform a statistical sample of the transactions to compute the allowable portion of the bad debt loss. Staff must follow the guidelines for performing a statistical sample set forth in Audit Manual Chapter 13. Staff must select a sample size to examine no fewer than 300 transactions. If the population is less than 300, the transactions should be examined on an actual basis. The lender must provide a listing for the sample that computes the allowable portion of the bad debt on a transaction-by-transaction basis in accordance with Regulation 1642(d). Staff must verify the accuracy of the sample data.

Under this method, the lender provided the total write off amount for the population. It includes items not allowable under Regulation 1642. The sample is used to compute an audited allowable amount on a transaction-by-transaction basis. Thus every transaction examined in the sample will show a difference between the audited and claimed bad debt. These differences must be evaluated using the Board's Statistical Sampling Evaluation program. When the sample evaluates well, it will be used to compute an audited allowable bad debt percentage. The allowable bad debt percentage is the audited allowable amount per the sample (computed in accordance with Regulation 1642) divided by the total bad debt claimed in the sample. The allowable bad debt percentage will be applied to the total claimed bad debt to arrive at the total audited allowable bad debt amount. If the sample differences do not evaluate well, staff should consider expanding the sample. On the other hand, the auditor may discover no material discrepancies after testing a sufficient portion of the sample that the auditor is comfortable in concluding the amount of bad debt loss claimed by the taxpayer is correct. If so, the auditor, in his or her discretion, may terminate the test and accept the amount of bad debt loss claimed by the taxpayer. In reaching this conclusion prior to completing the test, the auditor must consider all factors relevant to the sample, the most important of which is the size and uniformity of the population.

3. **Mean Allowable:** The third method is similar to the second method described above. Under this method a mean allowable bad debt per account is computed in lieu of an allowable percentage. The verification procedures staff must perform are identical to those described in method two above.

When the sample evaluates well, it will be used to compute an audited allowable mean bad debt per account.

The mean allowable amount per account is computed by taking the allowable write off amount per the sample (computed in accordance with Regulation 1642) divided by the total number of accounts examined in the sample. The mean allowable amount per account will be applied to the total number of accounts contained in the population to arrive at the total allowable bad debt. If the sample differences do not evaluate well, staff must expand the sample or provide adequate comments to support the application of the results of the sample.

**Required Documentation — Vehicles:** The following is a list of information staff must review when verifying a claimed bad debt deduction or refund incurred in connection with the financing of a vehicle. However, to the extent this information is not relevant to the actual computation of the allowable bad debt deduction or deallocation of tax, it need not be scheduled. For example, if a statistical sample uses the loan origination number as the basis for selection, this number must be available for all transactions within the population and must be scheduled. If there is a valid reason for not scheduling that information, adequate supporting comments must be included explaining how the information was made available and why it was impractical to include such information in the supporting schedules.

#### **Total Population of Claim on Electronic Media (disc or CD-ROM)**

- Must exclude or readily identify loans that do not qualify
- Must identify loan origination date (date contract entered into)
- Must include seller's/dealer's name and address (city and state)
- Must include consumer's name and address (city and state)
- Must include the following additional information:
  - Reference number – number assigned to each loan
  - Type of vehicle/property – e.g., vehicle, RV, mobile home, etc.
  - Date of repossession charge off – the date charged off for income tax purposes
  - Loan number – actual loan account number
  - Charge off or loss per records – amount charged off for income tax purposes
  - Summarized number of transactions in each local tax and district tax area

#### **Sample Selection**

- Minimum sample size of 300 loan contracts selected using statistical sampling procedures (i.e., random, systematic with random start, etc.). If the total population is equal to or less than 300, verification will be on an actual basis.
- For each loan in the sample - evidence that the uncollectible portion has been charged off for income tax purposes or in accordance with GAAP. Printouts from taxpayer accounting system will suffice.
- For losses claimed under Regulation 1642(h)(3) and (i), an election agreement for each loan as required by Regulation 1642 (i)(3)(A) and, if applicable, the election agreement required by either Regulation 1642 (h)(3)(A) or (i)(4)(A).

### **Documentation and Information for Selected Sample**

- Complete contract file, including the “No Recourse” statement. If “No Recourse” statement is not available, copy of the contract/agreement between dealer and the financial institution establishing that the lender holds the account without recourse.
- Reference number – number assigned to each loan
- Loan origination date – date contract entered into
- Date of repossession charge off – the date charged off for income tax purposes
- Loan number – actual loan account number
- Sales price of vehicle – total amount subject to tax including document preparation charge and taxable smog
- Nontaxable charges such as charges for optional service contracts, Smog Impact Fee, Smog Check Certificate fee, etc.
- Sales tax reimbursement collected from the consumer on sale
- Vehicle License Fee
- Insurance – net amount
- Down payment
- Any adjustments to the principal
- Finance charges – net amount
- Payments on principal
- Value of repossession – sales price for subsequent sale
- Charge off or loss per records – amount charged off for income tax purposes
- Repossession expense – auctioneer’s fees, reconditioning, etc.
- Recovery – payments made after the loan is charged off on records
- Reversals – adjustments for non-sufficient funds (NSF) checks, etc.
- Taxpayer must compute the amount of refund per Regulation 1642

**Local Tax Verification:** When reviewing a claim for refund under WFS or Regulation 1642(h)(3) and (i), it is imperative the local and district taxes are properly deallocated. For example, when the claimed bad debt loss relates to sales of vehicles, the name and address of the dealer and consumer must be included for each transaction scheduled to properly deallocate the local and district taxes on an actual basis. For loans approved by the lender on a transaction-by-transaction basis, the lender should allocate the local and district taxes on an actual basis. In cases where transaction-by-transaction information is not available and the deallocation cannot be done on an actual basis, the regulation provides that the lender may allocate local and district taxes on an appropriate basis subject to approval by the Board. When verifying the accuracy of such an alternative method, the field auditor must fully explain (1) the basis for concluding whether the alternative method is accurate and (2) specifically how the local tax deallocation

was calculated.

## CREDIT FOR TAX PAID TO OTHER STATES, SECTION 6406 CREDIT

0419.20

Credit for sales or use tax imposed by other states and paid on purchases of tangible personal property may be taken as a credit against the amount of tax due. The property must have been purchased for use, consumption or storage (not resale) in California, ~~and the tax paid must have been legally due in the state to which it was paid.~~ The department's administrative practice is not to question the validity of the imposition of a tax by another state. If the purchaser can show that tax was paid to another state on a transaction subject to use tax in California, the credit is allowable.

The only two exceptions to this general practice are: (1) when the taxpayer obtains a refund of the tax paid to the other state prior to our review of the transaction, or (2) when it can be shown that the purchaser or vendor is intentionally reporting tax to the other state in order to take advantage of the section 6406 credit.

With respect to vehicles, vessels and aircraft, the section 6406 credit shall be denied when tax on the sale or purchase of the vehicle, vessel or aircraft was first due in California.

Auditing procedure normally includes verifying the purchase invoices to ascertain that the purchase price was included on Line 2 of the return and to verify the amount of section 6406 credit claimed on the return. The auditor must also verify that the tax (amount of credit claimed) was paid either to the retailer located in another state or to that state itself. ~~The tax which was paid must have been properly imposed on the purchaser.~~ Section 6406 also provides that credit is not allowed on out of state tax measured by periodic payments made under a lease for a period prior to the storage, use or other consumption of the property in this State.

The amount of tax credit claimed may not exceed the lesser of (1) the tax actually paid and owed to another state, or (2) the tax computed using the combined state and local tax rates in effect at the time the property was first brought to California. Section 0203.16 describes the method of handling the difference developed in this portion of the audit.

The section 6406 credit is apportioned to the county tax and transit tax against which it is allowed in proportion to the amounts of those taxes.

## AUDIT OF CHARITABLE ORGANIZATIONS

0419.30

Sales made by charitable organizations are exempt provided the conditions included in Regulation 1570 are met. Compliance Policy and Procedures Manual section 255.050 also contains information relating to charitable organizations.

Included among the conditions that must be met is that each year a "welfare exemption" from property taxation must be secured. The exemption claim is filed through the County Assessor's Office by March 15 of each year. Sales are taxable during a year for which an organization does not qualify for a "welfare exemption." The procedure by which an organization qualifies for an exemption appears in CPPM. The auditor should ascertain that the exemption covers all real and/or personal property owned by the organization and situated at the location from which the sales are made. An organization not owning the real property must qualify for an exemption of the personal property at that location.

Organizations that started after the filing date should make application to the County Assessor to find out whether or not they qualify for the exemption. The organization should receive a letter, which informs them that they qualify, from the Assessor or ~~Division of Assessment Standards~~ the Assessment Policy and Standards Division of the Board's Property and Special Taxes Department. Such a letter exempts them from the payment of sales tax pending their qualifying at the normal filing time.

Sales or use tax applies to sales to charitable organizations of tools, supplies, and equipment when the property is used or consumed by the organization. Effective January 1, 1990 sales or use tax does not apply to purchases by the organization of tangible personal property for the purpose of donation.

## **AUDIT OF WATERCRAFT EXEMPTION CERTIFICATES**

**0419.35**

All claimed exempt watercraft sales must be supported by properly completed exemption certificates. It is especially important that questionable certificates be followed up to substantiate their validity.

Occasionally a purchaser may issue an exemption certificate for items that may be taxable or nontaxable depending upon attachment and/or usage. In which case, items of a consumable nature should be considered as taxable unless the purchase order indicates these items as exempt.

The sales of watercraft and their component parts are exempt, provided the conditions included in Regulation 1594 are met.

To be considered a "component part" of a watercraft for purposes of the exemption the property must be an integral part of the watercraft, affixed or attached thereto in a substantial manner when in use. All property affixed or attached to the structure of the watercraft used while thus affixed or attached for navigation, operation, or for the comfort or convenience of the passengers and crew is exempt.

Property is not considered a component part of a watercraft for purposes of the exemption if it is a kind commonly treated as expense items and is not affixed or attached to the watercraft in a substantial manner when in use. For further details, see Pamphlet Number 40, Tax Tips For The Watercraft Industry.

~~During an audit of a California aircraft dealer or dealer/broker the auditor shall schedule leads on certain apparently valid and properly supported exempt sales of aircraft as follows:~~

- ~~• All exempt sales to nonresidents other than bonafide dealers~~
- ~~• Any exempt sales to common carriers or foreign governments which seem to be valid but which might have some questionable aspects~~
- ~~• All brokerage transactions~~

~~Form, BOE 379 A, Aircraft Exempt Sale Referral, was developed for this purpose (Exhibit 11). The auditor shall perform sufficient verification to ensure that no transactions are listed which are properly the liability of the taxpayer under audit, i.e., list only transactions which audit verification indicates are the responsibility of the purchaser rather than the dealer.~~

~~Whenever the auditor disallows sales of aircraft to nonresidents, convincing verification should be obtained that the purchaser was or is a California resident. Evidence of a factual abode of some permanency in California should be obtained in these situations.~~

~~It should be determined that the dealer has not in effect encouraged false documentation. If it can be established that the dealer knew the facts stated in the documentation were not true, the tax plus applicable interest and penalties should be assessed against the dealer. A dual determination against the purchaser might be justified in some situations.~~

~~All such listings of transactions should provide as much information as possible but should include as a minimum: The name and address of the purchaser and seller; the type of aircraft including make, size, description and identification number; the state in which the aircraft is registered; the selling price; and the basis on which the transaction was claimed as exempt, i.e., nonresident, common carrier, foreign government or brokerage. A separate Form BOE 379 A should be prepared for each transaction.~~

~~Transactions should also be listed during audits of other accounts involving exempt sales or aircraft where the purchaser would be responsible for tax such as:~~

- ~~• Sales of aircraft by other instate sellers (nondealers) to residents and nonresidents.~~
- ~~• Sales of aircraft by out of state sellers (dealers and nondealers) to California residents and sales to nonresidents that may have some indications that the aircraft was purchased for use in California.~~

~~The Forms BOE 379 A on such ostensibly exempt sales transactions should be forwarded directly to the Consumer Use Tax Division. They will correlate this data with their own sources of information and prepare use tax billings where appropriate.~~

## **NEW OR REMANUFACTURED TRUCKS, TRUCK TRACTORS, TRAILERS, OR SEMITRAILERS**

**0419.45**

Sections 6388 and 6388.5 provide sales and use tax exemptions on the sale, or storage, use or other consumption of certain vehicles and trailers delivered inside California. Regulation 1620.1, *Sales of Certain Vehicles and Trailers for Use in Interstate or Out-of-State Commerce*, clarifies these exemptions and describes the records needed to support the exemptions.

### **Section 6388 Exemption (Regulation 1620.1(b)(2)):**

This exemption typically shows up in audits of vehicle manufacturers or remanufacturers who deliver a vehicle [as defined in subdivision 1620.1(a)(8) "vehicle" includes certain trailers] to a purchaser who is not a resident of California for use exclusively in out-of-state or foreign commerce, when the purchaser:

1. Purchases the vehicle from a dealer located outside California,
2. Removes the vehicle from California within 30 days from the date of delivery,
3. Provides an affidavit to the manufacturer or remanufacturer, stating:
  - a. The name and location of the out-of-state dealer from whom the vehicle was purchased,
  - b. The name and location of the in-state manufacturer or remanufacturer that delivered the vehicle to the purchaser and the date of delivery,
  - c. That the purchaser is not a resident of California,
  - d. That the vehicle was purchased for use exclusively outside California,
  - e. That the vehicle was removed from California within 30 days of the delivery date, and
  - f. The date of removal, and
4. Provides evidence of out-of-state vehicle registration [state of registration, license plate number and Vehicle Identification Number (VIN) or serial number] to the manufacturer or remanufacturer within 60 days of providing the affidavit to the deliverer.

To file the affidavit, the purchaser should use form BOE-837. Alternative documentation is permissible as long as it contains all the information required by form BOE-837.

**Audits of vehicle manufacturers and remanufacturers:** Manufacturers and remanufacturers should have an affidavit and registration documentation on file to support a claimed exempt transfer of a vehicle. Note: It is rebuttably presumed that a vehicle registered outside California and apportioned for use within California is not purchased for use exclusively outside California.

**Audits of purchasers:** The Board may audit purchasers claiming exemption under Regulation 1620.1(b)(2). Under this exemption, purchasers must maintain internal records documenting that the qualifying vehicle was taken out of California within the time mandated by statute and was used exclusively outside California. Examples of documentary evidence are bills of lading showing the first functional use of the vehicle, vehicle logs/reports, fuel receipts, hotel bills, and copies of license or registration fee receipts showing the date of payment. Purchasers should also be able to show that they are residents of somewhere other than California.

### **Section 6388.5 Exemption (1620.1(b)(3)):**

This exemption typically shows up in audits of trailer manufacturers or remanufacturers, dealers, or purchasers. To qualify for exemption, the purchaser must use the trailer exclusively in interstate, out-of-state, or foreign commerce and meet the following criteria:

1. A trailer that is manufactured or remanufactured outside California must be removed from California within 30 days from the date of delivery; or a trailer that is manufactured or remanufactured within California must be removed from California within 75 days from the date of delivery.
2. If the trailer is registered outside the state, the purchaser or purchaser's agent provides the delivering manufacturer, remanufacturer, or dealer a copy of the current out-of-state license and registration for the trailer showing the VIN or serial number; or, if the trailer is registered in-state under the PTI (Permanent Trailer Identification) program, the purchaser or purchaser's agent provides the delivering manufacturer, remanufacturer, or dealer a copy of the federal document assigning or confirming the purchaser's or lessee's USDOT (United States Department of Transportation) number, FMC (Federal Maritime Commission) number, or a copy of the current SSRS (Single State Registration System) filing with the DMV. A purchaser or purchaser's agent may not use an FMC number if the purchaser has a current USDOT number. Evidence of registration outside California must be submitted to the dealer, manufacturer, or remanufacturer no later than 60 days after the timely providing of an affidavit described in subdivision 1620.1(b)(3)(A)3. Evidence of a USDOT number, FMC number, or SSRS filing must be submitted with the affidavit. [Descriptions of the PTI, USDOT, FMC, and SSRS programs are described in Regulation 1620.1(a).]
3. The purchaser or purchaser's agent must also provide a valid affidavit to the manufacturer, remanufacturer, or dealer, stating:
  - a. The name and location of the dealer from whom the trailer was purchased,
  - b. The name and location of the California dealer, manufacturer or remanufacturer that delivered the trailer to the purchaser and the date of delivery,
  - c. That the vehicle was purchased for use exclusively outside the state, or exclusively in interstate or foreign commerce, or both,
  - d. That the vehicle was removed from the state within the appropriate time periods provided for in subdivision 1620.1(b)(3)(A)(1), and
  - e. The date of removal.

As noted in the previous section, the purchaser must use form BOE-837 or its equivalent as the affidavit.

**Audits of purchasers:** Purchasers of trailers under this exemption must maintain internal records documenting that the qualifying trailer was taken out of California within the mandated time and was used exclusively in out-of-state, foreign or interstate commerce. Examples of documentary evidence are bills of lading (also indicating the first functional use of the vehicle), vehicle logs/reports, fuel receipts, hotel bills, and copies of license or registration fee receipts showing the date of payment.

Note: the exemption under 1620.1(b)(3) only applies to trailers and semitrailers – it does not apply to trucks or truck tractors.

All claimed exempt sales of new or remanufactured vehicles must be supported by written evidence of out of state license and/or registration and an affidavit as required by section 6388 or 6388.5. The affidavit can be in any form provided it satisfies the requirements of those sections (Exhibit 12). However, for any affidavit to be valid, written evidence of out of state license and/or registration is required. The written evidence of out of state license and/or registration can be in the form of a prorated registration even though the vehicle is base-plated in California.

In auditing a purchaser who is engaged in business in this state, the purchaser must provide documentary evidence that any vehicle claimed as exempt pursuant to section

~~6388 or 6388.5 was removed within the time provided by these sections. Examples of documentary evidence are fuel receipts, hotel bills, bills of lading for the first use of the vehicle and copies of license or registration fee receipts showing the date of payment. For the exemption under section 6388 to apply, the purchaser must also show that the vehicle was first used and functionally used thereafter out of state. For the exemption under section 6388.5 to apply, the purchaser must also show that the vehicle was used exclusively outside the state, or exclusively in interstate or foreign commerce, or both.~~

~~An example of use in interstate commerce is if the purchaser removed the trailer or semitrailer from this state within the appropriate time limits with an interstate payload. Failure of the purchaser to substantiate compliance with these two requirements are grounds for disallowance of the exemption and assessment of sales tax against the purchaser measured by the acquisition cost of the vehicle.~~