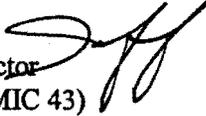


Memorandum

To : Ms. Kristine Cazadd
Interim Executive Director (MIC 73)

Date: April 14, 2011

From : Jeffrey L. McGuire, Deputy Director
Sales and Use Tax Department (MIC 43) 

Subject : Board Meeting, April 26 – 27, 2011
Item N: Administrative Agenda
Proposed Revisions to Audit Manual Chapters 2 and 5

In accordance with the established procedures for audit and compliance manual revisions, I am submitting the following proposed audit manual revisions:

AM Chapter 2, Preparation of Field Audit Report

- Section 0206.21 provides more specific guidance to staff on how to identify the North American Industry Classification System (NAICS) code that most accurately describes the taxpayer's primary business activity.
- Section 0207.20 provides a description and the procedures for holding a "10-day district office discussion" of a disputed audit.

AM Chapter 5, Penalties

- Section 0501.22 deletes the last two sentences because, as written, they conflict with 0501.15, and 0501.15 is correct; the negligence penalty and the penalty for failure to file are mutually exclusive and they can never apply to the same liability.
- Section 0506.30 clarifies the preparation of audit reports in cases where penalties apply only to a part of the audit period.

The proposed revisions have been reviewed and approved by SUTD management, and posted for 60 days on the Board's website (<http://www.boe.ca.gov/sutax/pmr.htm>) to solicit comments from interested parties. The Board members were notified accordingly. We received no comments from the public.

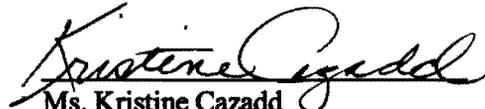
A copy of the new AM section 0207.20 and the revised AM sections 0206.21, 0501.22 and 0506.30 are attached for your reference. We request your approval to forward them to the Board Proceedings Division for placement on the next Administrative Agenda as a consent item.

If you have any questions, please let me know or contact Ms. Susanne Buehler at 324-1825.

JLM:nvm
Attachment

ITEM N4
04/27/11

Approved:


Ms. Kristine Cazadd
Interim Executive Director

cc:

(all without attachments)
Mr. Stephen Rudd (MIC 46)
Ms. Freda Orendt (MIC 47)
Ms. Susanne Buehler (MIC 92)
Mr. Kevin Hanks (MIC 49)
Ms. Kelly Reilly (MIC 47)

STATE BOARD OF EQUALIZATION



BOARD APPROVED

At the April 27, 2011 Board Meeting


Diane G. Olson, Chief
Board Proceedings Division

Business Code

Sales and Use Tax and Special Taxes accounts are populated with a six-digit North American Industry Classification System (NAICS) code. It is the taxpayer's primary business activity, not what the taxpayer sells, that predominantly determines the taxpayer's NAICS code. The *primary business activity* is the main activity from which the business generates the majority of its revenue and incurs most of its costs. The primary business activity may not be directly related to a taxable activity.

The auditor must verify that the taxpayer's NAICS code accurately identifies the taxpayer's primary business activity by looking up the code in the BOE NAICS Code Generator (Generator). The first two digits of the BOE NAICS code represent the Industry Sector (Sector Code). The Generator provides the Class Description for the Sector Code. The Sector Code and the Class Description must accurately identify the taxpayer's primary business activity.

~~Since the compliance staff depends upon the "class of business" comments to determine the correctness of the business code of record, the auditor will write a concise but adequate description of the taxpayer's business, with emphasis on the major or predominant activity. As a standard procedure, the auditor should verify that the business is coded correctly (Business Taxes Code Book section 203.000).~~

Special comments are required for the following types of business:

- Grocery Store — Beer, wine, liquor, meat, or produce departments (see AM Chapter 9, *Grocers*).
- Restaurant — Beer, wine, liquor, drive-in, and extent and type of take-outs (see AM Chapter 8, *Bars and Restaurants*).
- Construction Contractor — Lump-sum/time and material/cost plus contracts, subcontracts, and over-the-counter sales (see AM Chapter 12, *Construction Contractors*).

When a significant change in the business activity of an active account has occurred before or during the audit period or, if the ~~business was coded~~NAICS Code is incorrectly ~~ly when the permit was issued~~, the auditor must notify District Compliance as discussed in AM section 0219.03.

NAICS Code

~~On March 6, 2006, the Board implemented the use of codes identified in the North American Industrial Classification System (NAICS) in registering new Sales and Use Tax accounts. The six-digit NAICS codes will be phased in to replace the existing two digit Business Code. When conversion to the NAICS codes is complete, the auditor will verify that the taxpayer's business is coded correctly using the NAICS Code Generator.~~

10-DAY DISTRICT OFFICE DISCUSSION

0207.20

The “10-day” district office discussion is the taxpayer’s next step following the exit conference if there are any remaining disputed items. It is initiated by the taxpayer’s response to Form BOE-79-A, an audit transmittal letter that allows a taxpayer who does not concur with the audit recommendation “10 days” to respond and arrange for a discussion of the non-concurred items. It is the District Principal Auditor’s (DPA) responsibility to hold the 10-day office discussion. However, the DPA may designate someone, other than the exit conference supervisor, to hold the discussion.

A completed Form BOE-836-A, *Report of Office Discussion*, is required for all non-concurred audits, field billing orders, and telephone billings for which a 10-day discussion is held. Form BOE-836-A must document any adjustments to the audit as a result of the 10-day discussion, as well as any items for which the taxpayer is still in disagreement. The DPA must approve and sign Form BOE-836-A in all cases. The completed form must be included in the audit report as outlined on Form BOE-1161, *Audit Arrangement Sheet* (Exhibit 27).

The DPA or designee must attempt to contact the taxpayer by telephone to schedule a district office discussion if the taxpayer fails to respond to Form BOE-79-A or when a telephone billing is needed to protect the statute of limitations of a completed audit. The DPA or designee’s efforts to make contact with the taxpayer should be clearly documented in the auditor’s “Discussion with Taxpayer” comment in the "General Audit Comments" section of Form BOE-414-A and Form BOE-414-Z.

TYPES OF PENALTIES — OVERVIEW
MANDATORY VS DISCRETIONARY PENALTIES

0501.22

Numerous sections of the Revenue and Taxation Code (RTC) impose penalties. Some penalties are mandatory and are imposed automatically. Other penalties are discretionary and may be assessed ~~by auditors in the conduct of their audits based on the -auditor’s judgment to and facts supporting the specific penalty.~~ (See AM section 0203.21 for typical ~~explanations of~~ penalty recommendations in sales and use tax audits.

~~Whenever circumstances warrant the imposition of either a mandatory or a discretionary penalty, but not both, the mandatory penalty will apply. For example, the penalty for failure to file a return (mandatory penalty) rather than the negligence penalty (discretionary penalty) should be applied in those cases where either penalty is applicable.~~

The tables that follow classify penalties as mandatory or discretionary.

Mandatory Penalties

Nature of Penalty	Rate	RTC Sections
Failure to file a return	10%	6511; 6591
Failure to pay taxes	10%	6565; 6591
Failure to pay prepayment amounts	6%	6476; 6477
Electronic Fund Transfer (EFT) related penalties exclusive of prepayments	10%,	6479.3
Failure to pay prepayments by EFT	6%	6479.3
Amnesty interest penalty	50% ^a	7074
Double amnesty penalty	^b	7073
Failure to pay prepayment amounts by suppliers and wholesalers of fuel	10% ^c	6480.4

^a This penalty applies only to periods eligible for amnesty and is based on the unpaid tax as of March 31, 2005 (see AM sections 0505.00 – 0505.10 for more information).

^b This penalty applies only to periods eligible for amnesty and is applicable to a Notice of Determination issued after April 1, 2005 (see AM sections 0505.00 – 0505.10 for more information).

^c The rate of penalty is increased to 25 percent if the supplier or wholesaler knowingly or intentionally fails to make a timely remittance of the prepayment amounts.

Discretionary Penalties

Negligence or intentional disregard of the law or authorized rules and regulations	10%	6478; 6484
Fraud or intent to evade the law or authorized rules and regulations	25%	6485; 6514
Improper use of a resale certificate for personal gain to evade the tax	^d	6072; 6094.5
Failure to remit sales tax reimbursement or use tax collected	40% ^e	6597
Knowingly fails to obtain a valid permit for the purpose of evading the payment of tax	50%	7155
Registration of a vehicle, vessel, or aircraft outside the State of California for the purpose of evading the payment of tax	50%	6485.1; 6514.1
Failure to obtain evidence that the operator of catering truck holds a valid seller's permit	\$500	6074
Failure of a retail florist to obtain a permit before engaging in or conducting business as a seller	\$500 ^f	6077

^d 10% of the tax due or \$500 whichever is greater.

^e RTC section 6597 operative January 1, 2007.

^f Plus any other applicable penalties.

PENALTIES APPLICABLE TO ONLY PART OF AUDIT PERIOD

0506.30

Situations may be encountered where the condition warranting the imposition of a negligence penalty is not present during the entire period under audit and where the imposition of the penalty to the entire amount of the tax liability would be inequitable. For example, a complete change of management occurred and conditions under one management were entirely different from those under the other. In this type of situation the auditor will prepare two sets of Form BOE-414-A or Form BOE-414-B, one includes the 10 percent penalty [for the period in which it is imposed](#), and the other without the penalty. Audit Determination and Refund Section will issue ~~the two~~ [Notices](#) of Determination accordingly. The audit report with the penalty must include a full statement of the facts involved.

When considering the recommendation to impose a negligence penalty on a partial audit period, auditors should determine if the taxpayer made any effort during a subsequent period in the audit to correct the situation which led to negligence. If such an effort has been made, a penalty may not be appropriate.