CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION FINAL ACTION SUMMARY

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of:	
WCN, INC.	Account Number: SR AS 97-952302 Case ID 491680
Petitioner	Los Angeles, Los Angeles County

Type of Business: Seller of computers

Audit period: 07/01/04 – 12/31/07

Item	Disputed Amount
Unreported taxable sales	$319,570
Disallowed claimed sales for resale	$175,990
Disallowed claimed interstate commerce sales	$1,158
Negligence penalty	$4,098

	Tax	Penalty
As determined	$127,795.06	$12,779.53
Pre-D&R adjustments	- 8,583.88	- 858.37
Post-D&R adjustments	- 78,231.87	- 7,823.21
Proposed redetermination, protested	$ 40,979.31	$ 4,097.95

Proposed tax redetermination	$40,979.31
Interest through 08/31/14	27,274.49
Negligence penalty	4,097.95
Total tax, interest, and penalty	$72,351.75
Monthly interest beginning 09/01/14	$ 204.90

The Board heard this matter on February 26, 2014, and granted petitioner 30 days to provide additional records and the Sales and Use Tax Department (Department) 30 days to respond. Based on petitioner's submissions and the Department's response, we do not recommend adjustments, as explained below under Post Hearing Developments. This matter was scheduled on the adjudicatory calendar for the July 2014 Board meeting, but was postponed at petitioner's request that the matter be moved to a meeting in Culver City to enable petitioner to make a public comment.

UNRESOLVED ISSUES

Issue 1: Whether any further adjustments are warranted to the amount of unreported taxable sales. We find no further adjustments are warranted.

Petitioner sells computers and component parts and has been in business since November 2001. Petitioner also repairs computers. For audit, petitioner provided bank statements for the period July 1, 2004, to June 30, 2007, and income statements for 2004, 2005 and 2006. Since petitioner could not provide all of its sales invoices and a detailed summary of its sales, such as a sales journal, the Department established gross receipts using bank deposits.

Initially, the Department established unreported taxable sales of $1,099,639. Based on documentation provided prior to the appeals conference and after the D&R was issued (in a request for reconsideration), the Department concluded that unreported taxable sales should be reduced to $747,657. However, we found errors in the Department's calculations, and, in a supplemental D&R, we recommended that unreported taxable sales be further reduced to $319,570.

Petitioner contends that the excess bank deposits do not represent unreported taxable sales and that further adjustments are warranted for nontaxable sales of optional maintenance contracts. The Department found that the sales invoices petitioner provided were insufficient to conclude whether the maintenance contracts were optional or mandatory, and more importantly, whether any of the proceeds from the sales of maintenance contracts were included in the bank deposits. We concur with the Department's conclusion, and we reject petitioner's contention that further adjustments are warranted.

Issue 2: Whether further adjustments are warranted to the disallowed claimed sales for resale. We find no further adjustments are warranted.

Initially, the Department disallowed all of petitioner's claimed sales for resale. Subsequent to the appeals conference, petitioner provided sales invoices and documentation to support sales for resale totaling $209,723, which the Department accepted. However, petitioner provided no sales invoices or documentation to support any of the remaining claimed sales for resale.

Petitioner contends further adjustments are warranted and that the remaining disallowed sales for resale should be accepted. In the absence of any supporting documentation, we conclude that no further adjustments are warranted and we recommend none.

Issue 3: Whether further adjustments are warranted to the disallowed claimed sales in interstate commerce. We find no further adjustments are warranted.

Initially, the Department disallowed all of petitioner's claimed sales in interstate commerce. Subsequent to the appeals conference, petitioner provided sales invoices and documentation to support sales in interstate commerce totaling $39,073, which the Department accepted. However, petitioner provided no sales invoices or documentation to support any of the remaining claimed sales in interstate commerce.

Petitioner contends further adjustments are warranted for the remaining disallowed sales in interstate commerce. In the absence of any supporting documentation, we conclude that no further adjustments are warranted and we recommend none.

Issue 4: Whether petitioner was negligent. We conclude that petitioner was negligent.

The Department imposed the negligence penalty because petitioner failed to maintain adequate records, and because the understatement is large relative to reported taxable sales. Petitioner disputes the negligence penalty on the grounds that the understatement is excessive. Also, petitioner notes that this was petitioner's first audit.

A comparison of unreported taxable measure with reported taxable sales shows an error rate of 23,309 percent [($319,570 + $175,990 + $1,158) ÷ $2,131], which is strong evidence of negligence in reporting. Further, with the exception of the bank statements and income statements, petitioner failed to provide complete sales and purchase records for the audit period. Even though this was petitioner's first audit, we find that petitioner was negligent in both reporting and recordkeeping.

RESOLVED ISSUES

Initially, the Department included a separate measure of tax for unreported purchases of machinery and equipment, and a separate measure of tax for unreported purchases of furniture and fixtures. However, petitioner provided documentation supporting that the unreported purchases occurred outside the normal three-year statute of limitations. Consequently, the Department concluded both measures of tax should be deleted, and prior to the appeals conference prepared a reaudit to delete the measures of tax. We concur with the Department's recommendation.

OTHER MATTERS

None.

POST HEARING DEVELOPMENTS

As explained above, petitioner's records were incomplete, and, as a result, the Department established gross receipts using bank deposits. At the Board hearing, petitioner argued that some of the amounts deposited in the bank represented payments for nontaxable labor rather than retail sales of tangible personal property. Some of the discussion at the Board hearing centered around the difficulty the Department had determining whether the contracts and invoices provided by petitioner related to amounts that were deposited into the bank accounts that were used to develop audited sales. The Department expressed concern that the copies of checks provided as support for the purported receipts from nontaxable services only showed the fronts of the checks, which did not provide the information regarding the date of the deposit and the bank account number to which the checks were deposited (which would have been shown on the backs of the checks). Petitioner's representatives stated that they would provide copies of the fronts and backs of all relevant checks so that the payments could be traced to the specific bank account as well as to the contracts or invoices. There was also discussion of the income tax returns, which apparently had not been filed at the time of the audit. The Department indicated that the income tax returns could provide information regarding the cost of goods sold, which might offer some information regarding petitioner's sales of tangible personal property. Petitioner stated that the income tax returns had been filed and could be provided.

After the hearing, petitioner provided copies of the front of some checks and copies of deposit slips with no markings indicating that the deposit slips had been processed by the bank. Since petitioner did not provide copies of the backs of canceled checks, the Department was unable to verify that the checks at issue were, in fact, deposited into the bank accounts for which records were provided. The Department also noted that the amounts shown on some of the checks did not match deposits in the bank. To explain those differences, petitioner provided deposit slips that showed an amount of cash taken out at the time of the deposit. Although the primary issue remains the documentation of specific deposits to the bank accounts for which statements were provided, the Department also noted that the withdrawal of cash is evidence that the bank deposits do not represent all of petitioner's receipts since some portion of its receipts were not deposited in the bank.

Petitioner also provided copies of unsigned income tax returns for 2004 and 2007. However, the Department concluded that the unsupported amounts of cost of goods sold reported on those returns did not represent reliable evidence of petitioner's transactions that included tangible personal property. Specifically, the Department was concerned that the amounts reported on income tax returns might be understated. As explanation, the Department noted that the income tax return for 2006 showed cost of goods sold of $51,705. However, for December 2006 alone, petitioner wrote checks for over $100,000, and a large percentage of those checks were issued to purchase other negotiable instruments, such as cashier's checks and money orders. Thus, the ultimate recipient of the funds could not be determined. The Department also noted multiple charges for overdraft fees, which it regarded as an indication that petitioner's vendors may have required payment by cashier's check or money order. In any event, since it is possible that some or all of the cashier's checks and money orders were purchased to pay vendors for purchases of inventory, the significant amount of those purchases appears to indicate that the reported cost of goods sold of $51,705 for 2006 was understated. Moreover, the Department requested petitioner's approval to contact its customers regarding the nature of their purchases. Petitioner declined to give that approval and stated that its customers would not provide records unless a subpoena was issued. In summary, the Department concludes that the documentation provided after the Board hearing is not sufficient to show that any of the amounts deposited in the bank represent receipts from exempt or nontaxable transactions. We concur, and we recommend no further adjustment.

Summary prepared by Lisa Burke, Business Taxes Specialist III