# CALIFORNIA STATE BOARD OF EQUALIZATION

## APPEALS DIVISION FINAL ACTION SUMMARY

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| In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of: | |
| Y & S ENTERPRISES, Inc., dba Y & S Auto Body Shop | Account Number: SR Y EA 14-775127<br>Case ID 492513 |
| Petitioner | San Pedro, Los Angeles County |

Type of Business: Auto body shop

Audit period: 10/01/04 – 12/31/07

| Item | Disputed Amount |
|---|---|
| Understatement of reported taxable sales | $2,643,537 |
| Negligence penalty | $ 28,269 |

| | Tax | Penalty |
|---|---|---|
| As determined | $386,086.64 | $38,608.70 |
| Post-Board hearing adjustment | - 103,396.03 | -10,339.59 |
| Proposed redetermination | $282,690.61 | $28,269.11 |
| Less concurred | - 64,598.75 | 00.00 |
| Balance, protested | $218,091.86 | $28,269.11 |

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|---|---|
| Proposed tax redetermination | $282,690.61 |
| Interest through 09/30/14 | 162,059.67 |
| Negligence penalty | 28,269.11 |
| Total tax, interest, and penalty | $473,019.39 |
| Payments | - 39,350.05 |
| Balance Due | $433,669.34 |
| Monthly interest beginning 10/01/14 | $ 1,216.70 |

The Board heard this matter on October 30, 2013, granting petitioner 30 days to provide additional records the Sales and Use Tax Department (Department) 30 days to reply. The matter was scheduled for consideration on the non-appearance calendar for April 2014, but was deferred at the request of the Appeals Division in order to allow time for the Department to conduct additional investigation. As a result of that investigation, we recommend a reduction in the measure of tax of $1,253,285, from $4,679,837 to $3,426,552, as explained under Post-Hearing Developments.

## UNRESOLVED ISSUES

**Issue 1:** Whether adjustments are warranted to the audited understatement of reported taxable sales. We find no adjustment is warranted, other than those explained under Post-Hearing Developments.

Petitioner has operated auto body shops since January 1989, and it operated at three locations during the audit period. For audit, petitioner provided federal income tax returns for 2004, 2005, 2006, and 2007; sales tax return worksheets for the fourth quarter of 2006 (4Q06) through 4Q07; job folders; and purchase invoices for fixed assets and self-consumed supplies.

The Department noted substantial differences between the gross receipts reported on petitioner's federal returns and the total sales reported on sales and use tax returns. Also, the Department reviewed the available sales tax return worksheets and discovered computational errors. The Department recalculated the taxable sales shown on the available worksheets and found that its recalculated taxable sales for 4Q06 through 4Q07 exceeded reported taxable sales by $977,998, which represented an error ratio of 41.68 percent. The Department applied that percentage to reported taxable sales for the remainder of the audit period to establish an understatement of reported taxable sales caused by computation errors in the sales tax worksheets of $2,508,670. The Department then traced information from 31 job folders, randomly selected by petitioner from all job folders for 2007, to the sales tax return worksheets. It found understatements in the recorded taxable sales for *each* of the 31 jobs. Based on a discussion with petitioner's in-house accountant, the Department determined that petitioner had erroneously posted an amount on the worksheets based on the cost of auto parts rather than their selling price. Using the information for those 31 transactions, the Department computed a percentage of error of 27.61 percent in the amounts recorded on the worksheets for individual transactions. The Department applied that percentage to the adjusted recorded taxable sales to compute an understatement of reported taxable sales due to posting errors of $2,171,166. In other words, the Department used a two-step process. It first re-calculated the amounts of taxable sales recorded on the sales tax return worksheets and found a difference between the re-calculated figures and reported amounts of $2,508,670 (computational errors). The Department then found that the amounts recorded on the worksheets for individual transactions were understated by $2,171,167 (posting errors). Thus, the understatement of reported taxable sales is the total of those amounts, $4,679,837.

Petitioner provided a sales summary at the appeals conference that shows an understatement of $783,015, and it disputes the balance of $3,896,822 ($4,679,837 - $783,015). With respect to the computation errors, petitioner concedes that there were errors on the worksheets reviewed by the Department, but argues that the errors for those five quarters should not be projected to the remainder of the audit period. Petitioner states that its former controller passed away at the end of 2006, and the new bookkeeper made errors in formatting the reports that caused the computer system to generate incorrect totals for the worksheets, but only starting with the fourth quarter of 2006. As support, petitioner has provided re-constructed sales tax return worksheets for the audit period.

Regarding the posting errors, petitioner contends that the percentage of error computed by the Department based on its review of 31 job folders should not be projected to all transactions. Although petitioner concedes that there were errors in the posting of sales data from the job folders to the sales tax return worksheets for each of the folders reviewed by the Department, it asserts that it did not make the same types of mistakes in posting other jobs. As support, petitioner has provided its own test of the posting of sales data for 77 jobs, asserting that the only posting errors it found were minimal and resulted in overstatements, rather than understatements of taxable sales.

With respect to the computation errors, we have reviewed the reconstructed worksheets provided by petitioner at the conference. We find that many repair orders are missing from the worksheets, and, for some of the repair orders recorded on the reconstructed worksheets, there is missing information for individual sales categories. As an explanation for these discrepancies, petitioner states that the repair orders are out of sequence because of the differing lengths of time it takes to complete various jobs and that some repair orders have missing details because those repair orders did not result in sales. However, petitioner has provided no documentation to support these assertions. Further, the amount of taxable sales recorded on the reconstructed worksheets for the period 4Q04 through 3Q06 total $2,878,142, compared to the $3,203,890 of reported taxable sales for the same quarters. The amounts of total sales recorded on the reconstructed worksheets are also substantially less than the amounts of gross receipts reported on federal returns for 2005, 2006, and

2007, and petitioner's only explanation is its unsupported assertion that the amounts reported on federal returns were incorrect.

We find that the amounts recorded on the reconstructed worksheets do not represent all of petitioner's sales, and that no adjustments are warranted to the understatement of $2,508,670 resulting from computation errors on the worksheets. Regarding the posting errors, we find it simply inconceivable that there would be posting errors for each of 31 jobs which were *randomly selected by petitioner*, and that there would be no other posting errors for any other job performed during the audit period except for minimal errors resulting in overstatements. Thus, we find that no adjustment is warranted to the understatement of $2,171,167 related to errors in posting individual sales to the sales tax return worksheets.

**Issue 2:** Whether petitioner was negligent. We conclude that it was.

The Department imposed the negligence penalty because petitioner failed to maintain adequate records for sales and use tax purposes and because the understatement represented amounts for which petitioner had collected the correct amount of sales tax reimbursement from its customers. Petitioner disputes the penalty on the basis that the understatement was due to computer system errors which began in 4Q06, after a change in accounting personnel, and because it was unaware of those errors.

The understatement of reported taxable sales of $3,426,552, after the post-Board hearing adjustments, represents an understatement of 64 percent of reported taxable sales of $5,355,060. Petitioner provided no sales and use tax worksheets for periods before October 2006, and in the available worksheets, there were substantial computation and posting errors. There are also substantial differences between the amounts reported on federal returns and on sales and use tax returns. We find that the magnitude of the understatement, the lack of supporting records, and the discrepancies in the records are evidence that petitioner did not exercise due care in reporting or in recordkeeping. Accordingly, we find that the understatement was the result of negligence, and the penalty was properly applied.

**POST HEARING DEVELOPMENTS**

During its post-hearing examination, the Department originally concluded that the additional records provided by petitioner did not support an adjustment. As explained in the hearing summary, under Issue 1, above, the Department had computed a percentage of error of 41.68 percent related to computation errors on sales and use tax return worksheets and a percentage of error of 27.61 percent related to errors in recording the amounts of repair orders to petitioner's summary records. First, the Department had reviewed sales tax return worksheets from the fourth quarter 2006(4Q06) to 4Q07 and had found numerous computation errors, from which it had computed a percentage of error of 41.68 percent, which it applied to reported amounts for periods prior to 4Q06.

Petitioner asserted that the errors found in the Department's test did not occur in the periods prior to 2007, and it provided reconstructed sales tax return worksheets and additional records, which the Department found unreliable for various reasons (i.e., on the allegedly corrected reports, there were significant unexplained gaps in the sequential repair order numbers; there were significant discrepancies between the sales shown on the "corrected" reports and the amounts reported for income tax purposes; and the amounts of sales on the "corrected" reports were lower than the cost of goods sold reported on the income tax return). We concurred with the Department's conclusion that the records provided to the Department after the Board hearing were not sufficient to warrant adjustments to the 41.68 percent of error related to computation errors on sales and use tax worksheets.

However, we expressed concern about the discrepancy between the Department's test of recording accuracy for the year 2007 and petitioner's test of periods prior to 2007. Specifically, the Department examined 31 repair orders randomly selected from job folders for 2007 and found that there were errors in the amounts recorded for each of those 31 orders. In contrast, petitioner provided 77 repair orders dated from 4Q04 to 2Q06, and asserted that each of those repair orders had been recorded accurately. Petitioner explained that its former controller had passed away near the end of 2006 and argued that the errors found by the Department for 2007 did not occur prior to that year.

Upon further review, the Department concluded that the error percentage of 27.61 percent that it had computed for its test of 31 repair orders from 2007 should not be applied to the recorded amounts prior to 2007. The Department has conducted an audit to make that adjustment, which resulted in a decrease in the audited understatement of reported taxable sales of $1,253,285, from $4,679,837 to $3,426,552. We concur with the Department's findings and recommend that reduction.

Summary prepared by Deborah A. Cumins, Business Taxes Specialist III