CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION BOARD HEARING SUMMARY

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of: G & C EQUIPMENT CORPORATION Petitioner	Account Number SR AS 97-832182 Case ID 373826 Gardena, Los Angeles County

Type of Business: Sales of construction materials and fixtures

Audit period: 04/01/02 – 03/31/05

Item	Disputed Amount
Disallowed nontaxable sales for second quarter 2002	$1,343,211

Tax as determined	$ 978,477.64
Pre-D&R adjustment	- 286,972.24
Post-D&R adjustment	- 105,981.54
Proposed redetermination	$ 585,523.86
Less concurred	- 477,176.91
Balance, protested	$ 108,346.95
Proposed tax redetermination	$ 585,523.86
Interest through 06/30/15	433,598.70
Amnesty interest penalty	1,655.20[1]
Total tax, interest, and penalty	$1,020,777.76
Payments	- 473,677.96
Balance Due	$ 547,099.80
Monthly interest beginning 07/01/15	$ 559.23

This matter was scheduled for Board hearing in October 2012, but was deferred at the request of the Appeals Division in order to issue a supplemental D&R (SD&R) to address petitioner's Request for Reconsideration. In the SD&R, no additional adjustments were recommended other than conditional relief of the amnesty interest penalty. This matter was rescheduled for Board hearing in February 2014, but was deferred at the request of the Sales and Use Tax Department (Department) in order to conduct further review. Following its review, the Department performed a reaudit, which

[1] Although we have recommended conditional relief of the amnesty interest penalty, the conditions have not yet been met, and the amnesty interest penalty will be added when the liability is redetermined. Accordingly, we include the penalty in the table as an amount due.

resulted in a reduction to the amount of disallowed claimed nontaxable sales from $2,816,954 to $1,399,648. This matter was rescheduled for Board hearing in August 2014, but it was postponed for settlement consideration.

UNRESOLVED ISSUE

Issue: Whether additional adjustments to the amount of disallowed claimed nontaxable sales for the second quarter 2002 (2Q02) are warranted. We find no further adjustment is warranted.

Petitioner sells and leases construction materials, tools, equipment, and supplies. Petitioner also provides procurement services and occasionally enters into construction contracts, for which it sub-contracts the construction work. For the first three quarters of the audit period, petitioner reported total sales and claimed deductions for exempt sales in interstate commerce and nontaxable sales of labor, but for the other periods, petitioner netted those deductions, such that its reported total sales and reported taxable sales were the same.[2] For audit, petitioner provided adequate records, including complete electronic records for the period July 1, 2002, through March 31, 2005. For the second quarter 2002 (2Q02), electronic sales data was not accessible because of a computer crash during a software conversion.

For each of the 11 quarterly periods for which electronic records were available, the Department found substantial differences between petitioner's recorded and reported taxable sales, with recorded taxable sales exceeding reported amounts by $4,505,635 overall. Thus, the Department established unreported taxable sales of $4,505,635 for the 11 quarters. The Department then used stratified statistical sampling to test the accuracy of petitioner's recorded nontaxable sales for those 11 quarters. The Department established three strata of sales ranging from $100 through $4,999.99, $5,000 through $49,999.99, and $50,000 and over. The understated amounts of reported taxable sales established for the three strata are $140,637, $563,139, and $632,205, respectively.[3] Petitioner does not dispute either the amount established as unreported taxable sales based on differences between

[2] For the fourth quarter of the audit period, petitioner did not claim deductions for exempt sales in interstate commerce or nontaxable sales of labor, but it did deduct $15,037 for the cost of tax-paid purchases resold.

[3] The Department reviewed all sales in the last stratum ($50,000 and over) on an actual basis and found errors representing about 1.4 percent of the total recorded nontaxable sales. For the other two strata, the Department chose random samples and found error rates of about 2.3 percent for sales less than $5,000 and about 4.2 percent for sales between $5,000 and $49,999.99, which it applied to the total sales in each stratum to establish disallowed claimed or netted nontaxable sales.

recorded and reported taxable sales, or the amounts established as disallowed claimed or netted nontaxable sales for the period July 1, 2002, through March 31, 2005.

For the second quarter 2002 (2Q02), the Department was unable to test a random statistical sample because the electronic sales data was not available. Instead, for 2Q02, petitioner provided a reconstructed schedule of sales produced from its customer history report, and the Department attempted to examine petitioner's recorded nontaxable sales for that quarter on an actual basis. Based on that examination, the Department disallowed recorded nontaxable sales of $2,816,954, or about 61.4 percent of petitioner's recorded nontaxable sales for 2Q02, because they were not supported by adequate documentation. However, petitioner argued that the Department could not have examined its sales in 2Q02 on an actual basis because not all of its documentation for that quarter was available, and contended that the flawed audit methodology had resulted in overstated taxable sales for 2Q02. In consideration of petitioner's argument as it prepared for the Board hearing in February 2014, the Department conducted further review and concluded that the measure of tax could be determined more accurately by using the audited taxable sales ratio computed from a comparison of audited taxable sales of $63,707,958 with petitioner's recorded total sales of $121,404,255 for the period July 1, 2002, through March 31, 2005. In the post-D&R reaudit, the Department applied the audited taxable sales ratio of 52.48 percent to petitioner's recorded total sales of $6,670,579 for 2Q02 to establish audited taxable sales of $3,500,445, which exceed petitioner's reported taxable sales for 2Q02 by $1,417,306. Since petitioner had claimed deductions for nontaxable sales of $4,153,643 for 2Q02, the Department established the deficiency of $1,417,306 as disallowed claimed nontaxable sales for 2Q02.

Petitioner contends that the taxable measure for 2Q02 should be $74,095, computed using the overall percentage of error established for the statistical sample, which petitioner calculates to be about 2.6 percent. Petitioner disputes the remainder of the amount disallowed for 2Q02, $1,343,211, and asserts that the use of statistical sampling for the entire period would generate a more accurate result. Petitioner also argues that the Sales and Use Tax Department Audit Manual (Audit Manual) requires the use of statistical sampling for the entire audit period, and cites section 1302.15 of the Audit Manual, which states in part that, in some instances, such as when documentation is not available for a portion of the audit period, results from a statistical sample may be projected to areas outside of the defined population.

We note that the total taxable measure of $5,841,616 established for the period July 1, 2002, through March 31, 2005, consists of two types of errors: 1) unreported taxable sales of $4,505,635 based on differences between recorded and reported taxable sales; and 2) disallowed recorded nontaxable sales of $1,335,981 based on statistical samples. Petitioner proposes that *only* the results of the statistical samples that were used to establish disallowed recorded nontaxable sales for the 11 quarters be used to establish *all* of the unreported taxable sales for 2Q02. Using petitioner's proposed methodology would require accepting that petitioner had accurately compiled and reported its recorded taxable sales for 2Q02, even though detailed sales records are unavailable to support the accuracy of recorded taxable sales for that quarter and substantial differences between recorded and reported taxable sales were found in each of the following 11 quarters. During its appeal, petitioner has discussed the advantages of using statistical sampling, and has pointed out that the statistical sample resulted in a reasonable approximation of tax due as evidenced by the statistical sample's confidence interval. While we agree that the amount of disallowed recorded nontaxable sales established for 11 quarters in the audit based on the statistical sample is reasonable, we reiterate that the amount of understatement based on the statistical sample is only one element of the total understatement for those 11 quarters. In other words, using only the percentage of error established using the statistical sample entirely ignores the much larger error identified for the 11 quarters, the difference between recorded and reported taxable sales. Thus, we find that petitioner's method to establish the understatement for 2Q02 does not effectively apply the audit findings for the 11 quarters to 2Q02.

We find that using the taxable sales ratio computed from a comparison of audited taxable sales with petitioner's recorded total sales for 11 quarters is a reasonable method for establishing audited taxable sales for 2Q02. Moreover, we note that audited taxable sales of $3,500,445 established for 2Q02 in the most recent reaudit are substantially less than average audited taxable sales of $5,791,632 per quarter established for the following 11 quarters. Therefore, we find that using the taxable sales ratio produced reasonable results, and conclude that no adjustment is warranted.

RESOLVED ISSUE

Petitioner's tax liability for the period April 1, 2002, through March 31, 2005, fell within the provisions of the amnesty program (i.e., amnesty-eligible periods). (Rev. & Tax. Code, § 7071.) Since petitioner did not participate in the amnesty program, an amnesty interest penalty will be added when the liability becomes final. After the reaudit adjustments, the amount of the amnesty interest penalty is $1,655.20. Petitioner has requested relief of the amnesty interest penalty on the basis that it was unaware of the deficiencies during the amnesty period, and the Department did not begin the audit until after the deadline for filing for amnesty had passed. The Department has concluded that petitioner's failure to participate in the amnesty program was due to reasonable cause, and we concur. Accordingly, we recommend relief of the amnesty interest penalty if, within thirty days of the Board's final action on this matter, petitioner either pays the tax and interest liability for the amnesty-eligible period in full or enters into an installment payment agreement to pay that amount over a period not to exceed 13 months and then successfully completes that agreement.

OTHER MATTERS

None.

Summary prepared by Lisa Burke, Business Taxes Specialist III