STATE BOARD OF EQUALIZATION
SALES AND USE TAX APPEAL

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:	)	
MORRISON AUTO CORPORATION, dba Morrison Auto Corp	)	Account Number SR KH 101-312584 Case ID 765464
Petitioner	)	Sacramento, Sacramento County

Type of Business: Auto paint supplies store

Audit period: 07/01/09 – 12/31/11

Item	Disputed Amount	
Unreported taxable sales	$431,390	
Tax, as determined		$40,252.87
Post-D&R adjustments		- 3,232.54
Balance protested		$37,020.33
Tax, as proposed to be redetermined		$37,020.33
Interest through 05/31/16		12,789.17
Total tax and interest		$49,809.50
Monthly interest beginning 06/01/16		$ 185.10

This matter was scheduled for Board hearing in January 2016, but petitioner did not respond to the Notice of Hearing, and the matter was scheduled for decision on the nonappearance calendar. Subsequently, petitioner contacted the Board Proceedings Division and requested that the matter be rescheduled for hearing.

UNRESOLVED ISSUE

Issue: Whether additional adjustments to the amount of unreported taxable sales are warranted. We conclude that no additional adjustments are warranted.

Petitioner has operated an auto paint supply store (dba Morrison Auto Paint & Supplies, hereafter "Morrison"), a vehicle repair shop (dba Victory Auto Collision Center, hereafter "Victory"), and auto paint spray booths for rental purposes, all under this seller's permit, since July 2009.

Petitioner did not include Victory's sales and its spray booth rental receipts in the total sales reported on its sales and use tax returns. For audit, petitioner provided its federal income tax returns,

bank statements, resale certificates, paint purchase invoices, spray booth purchase invoices and rental receipts, some sales invoices, and Victory's sales invoices for 2011.[1] The Business Tax and Fee Department (Department), formerly the Sales and Use Tax Department, found that the costs of goods sold reported on petitioner's income tax returns for 2010 and 2011 substantially exceeded the total sales reported on its sales and use tax returns for the same years, and concluded that further investigation was warranted.

The Department selected the second quarter of 2011 (2Q11) as a test period because it found that the amount of reported total sales for that quarter ($29,350) was the closest to average quarterly reported total sales of $30,224 for the audit period. The Department used Morrison's sales invoices for 2Q11 to compute recorded total sales of $84,026, including sales tax reimbursement, for that quarter. Adjustments to exclude sales tax reimbursement, and to allow 1 percent for estimated merchandise returns, resulted in audited quarterly total sales of $79,379 for Morrison. Of Morrison's recorded total sales for 2Q11, the Department computed recorded nontaxable sales for resale of $36,461. Based on its examination of the recorded sales for 2Q11, the Department disallowed recorded nontaxable sales for resale of $3,791, and further reduced the recorded nontaxable sales by 1 percent for estimated merchandise returns to establish audited quarterly nontaxable sales for resale of $32,343 for Morrison.

The Department then examined Victory's sales invoices for 2011, consisting of 42 transactions totaling $66,639, and computed $843 for sales tax reimbursement, $3,276 for nontaxable storage and hazardous waste fees, $4,979 for parts, $4,824 for paint and material, and $52,717 for nontaxable repair labor. The Department combined the nontaxable repair labor and storage and hazardous waste fees and established audited nontaxable sales of $55,993 for 2011, or quarterly nontaxable sales of $13,998 for Victory.

With respect to the auto paint spray booths, the Department found that petitioner had paid tax on its purchases of spray booth rental equipment, and concluded that its rentals of the equipment were not subject to tax. Based on spray booth rental receipts of $68,460 recorded in receipt books for 2011, the Department established audited nontaxable rental receipts of $17,115 per quarter.

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[1] Petitioner indicated that its sales records for 2009 and 2010 were destroyed and/or stolen when its shop was broken into.

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To establish audited total sales, the Department combined the 2011 Morrison sales of $317,516 ($79,379 x 4), Victory sales of $65,796 ($66,639 - $843), and spray booth rental receipts of $68,460 to compute audited total sales of $451,772 for 2011, which was consistent with gross receipts of $450,321 reported on petitioner's income tax return for 2011. The Department compared audited total sales of $451,772 with petitioner's reported total sales of $114,355 for 2011, and computed that the difference represented an understatement of 295.06 percent. Applying the error rate of 295.06 percent to petitioner's reported total sales of $302,240 for the audit period showed unreported total sales of $891,788, and audited total sales of $1,194,028 ($302,240 + $891,788) for the audit period. Based on its examination of Morrison's sales invoices for 2Q11, Victory's sales invoices for 2011, and the receipt books for spray booth rentals for 2011, the Department reduced audited total sales by $323,430 ($32,343 × 10 quarters) for nontaxable sales for resale, by $139,980 ($13,998 × 10 quarters) for Victory's nontaxable sales, and by $171,150 ($17,115 × 10 quarters) for nontaxable rental receipts to establish audited taxable sales of $559,468, which exceeded reported taxable sales by $467,727.

However, based on our recommendation at the appeals conference that the amount of nontaxable sales for each business be computed as a percentage of each business's audited total sales, the Department revised its audit methodology. The Department calculated that Morrison's sales represented 70.28 percent of audited total sales for 2011, Victory's sales represented 14.56 percent, and spray booth rentals represented 15.15 percent. Applying those percentages to audited total sales of $1,194,028 resulted in sales of $839,190 for Morrison, sales of $173,897 for Victory, and spray booth rentals of $180,939. The Department computed that 40.75 percent of Morrison's sales represented nontaxable sales for resale, 85.10 percent of Victory's sales represented nontaxable charges for repair labor and fees, and 100 percent of spray booth rentals were nontaxable. Using those percentages, the Department computed nontaxable sales for resale of $341,971, nontaxable repair labor and fees of $147,988, and nontaxable rental receipts of $180,939. The Department reduced audited total sales of $1,194,028 by nontaxable sales of $670,898 ($341,971 + $147,988 + $180,939) to establish audited taxable sales of $523,131, which exceed petitioner's reported taxable sales by $431,390, representing a reduction of $36,337 in the post-D&R reaudit.

On appeal, petitioner contends that audited sales for Morrison are overstated because its voided transactions and returned merchandise credits exceeded the 1 percent allowed in the audit. Petitioner explained that there were regulation changes in the auto paint industry during 2011 that forced auto repair facilities to switch from one type of paint to another, resulting in a significant amount of merchandise returns. Petitioner acknowledges that it did not contemporaneously prepare credit memos or otherwise record returned merchandise transactions, and states that the credit memos that it provided for audit only represent the merchandise returns that it could remember, and that there probably were many more returns than it can recall.

We note that the returned merchandise allowance of 1 percent of Morrison's sales is taken into account in the computation of audited total sales of $451,772 for all three businesses for 2011, which compares favorably with the gross receipts of $450,321 reported on petitioner's income tax return for that year. Thus, we find that the allowance of 1 percent appears to be reasonable, especially since the only records provided to support an allowance for returned merchandise were credit memos that petitioner generated from memory. We note that the credit memos could not be traced original sales that were included in reported taxable sales, and do not constitute evidence that the full sales price, including sales tax reimbursement, was refunded to the customer, or that the customer was not required to purchase other property at a price greater than the amount charged for the property returned. Given the lack of documentation to fulfill the requirements for the returned merchandise deduction explained in California Code of Regulations, title 18, section (Regulation) 1655 and Audit Manual section 0413.05, we find that the allowance for returned merchandise estimated as 1 percent of Morrison's sales is generous, and that no increase to the allowance is warranted. We have reviewed the computations in the post-D&R reaudit, and conclude that no further reduction to the amount of unreported taxable sales is warranted.

OTHER MATTERS

None.

Summary prepared by Lisa Burke, Business Taxes Specialist III