CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION SUMMARY FOR BOARD HEARING

In the Matter of the Petition for Redetermination and Claim for Refund Under the Sales and Use Tax Law of:	
ANTIQUE PORTRAITURE, INC.	Account Number: SR S AA 97-867850 Case ID's 351260 and 374301
Petitioner/Claimant	Pico Rivera, Los Angeles County

Type of Business: Mobile portrait studio

Audit period: 10/01/01 – 09/30/04
Claim period: 10/01/01 – 12/31/02

Item	Disputed Amount
Unreported sales	$1,290,589
Negligence penalty	$6,344
Claim for refund	$12,769[1]

	Tax	Penalty
Tax as established by audit:	$119,702.47	
Reported on amnesty returns	- 38,565.00	
As determined:	$81,137.47	$9,786.34[2]
Adjustment - Sales and Use Tax Department	-17,693.41	-3,441.84
Proposed redetermination, protested	$63,444.06[3]	$6,344.50

Proposed tax redetermination	$63,444.06
Interest through 10/31/10	46,976.42
10% penalty for negligence	6,344.50
Total tax, interest, and penalty	$116,764.98
Monthly interest beginning 11/1/10	$370.09

[1] This amount differs from the amount of claimed refund stated in the D&R of $6,100. Petitioner reported tax of $38,565 on amnesty returns and made payments totaling $12,768.79 on those returns during the period October 14, 2005, through October 17, 2008. Petitioner filed a claim for refund for an unstated amount on September 13, 2006. The D&R concludes that the claim for refund was timely for $6,100, the total amount paid in the six months preceding the claim. In general the six-month statute of limitations would apply because the claim for refund was filed more than three years after the due-dates for the returns for all of the quarters at issue. However, the amount reported on the amnesty returns was established in an audit and would have been included in the determination if petitioner had not filed amnesty returns. Under these circumstances, in order to avoid any harm to petitioner's appeal rights as a result of amnesty, we regard the claim as filed with respect to a determination, and find it is timely because it was filed before the determination became final.

[2] This includes an amnesty double negligence penalty of $1,672.54 that was imposed in error and removed in the reaudit.

[3] Petitioner protests the entire amount of tax established in the reaudit dated December 5, 2006, $102,009.06 ($63,444.06 determined + $38,565.00 reported on amnesty returns).

This matter was scheduled for Board hearing on June 17, 2010, but petitioner did not respond to the Notice of Hearing. Accordingly, the Board Proceedings Division informed petitioner that this matter will be presented to the Board for decision without oral hearing. Subsequently, petitioner contacted the Board Proceedings Division to request that it be given an oral hearing before the Board.

UNRESOLVED ISSUES

Issue 1: Whether further adjustments are warranted to the audited understatement of reported taxable sales. We find that no further adjustments are warranted, and that the claim for refund should be denied.

Petitioner has operated mobile family portrait studios since June 2001. Petitioner stated that its CPA prepared the sales and use tax returns (SUTR's) for the period October 1, 2001, through September 30, 2002, and for the third quarter 2004, and petitioner prepared the SUTR's for the period October 1, 2002, through June 30, 2004. Petitioner provided profit and loss statements (P&L's) and bank statements for the entire audit period. Also, for the periods October 1, 2001, through June 30, 2002, and July 1, 2003, through September 30, 2004, petitioner provided sales journals in which the recorded amounts represented the total sales for each week at the various locations, rather than detailed lists of individual sales. For the latter period, petitioner also provided sales invoices, which were not serially numbered. The Department found the invoices incomplete because the totals of the available invoices did not correspond to the amounts recorded in the sales journals. For the period July 1, 2002, through June 30, 2003, petitioner provided no sales journals or source documents. For the periods for which sales journals were available, the Department found no material differences between the amounts recorded in the sales journals and the P&L's. Further, the Department found that amounts recorded on petitioner's P&L's substantially reconciled with the amount of funds deposited in the bank. The Department found that the amount of total sales of $10,331,070, net of refunds, recorded on the P&L's for the audit period exceeded reported total sales of $8,965,129 by $1,365,941. Although the Department was not entirely convinced that the amounts recorded in the sales journals were complete, since they could not be verified using the available sales invoices, it noted that the sales journals reconciled with the only other summary records available, the P&L's and the bank statements.

The Department concluded that the sales journals provided the most reliable information available, and it used them to establish audited taxable sales.

To establish audited taxable sales for the periods October 1, 2001, through June 30, 2002, and July 1, 2003, through June 30, 2004 (for which sales journals were available), the Department scheduled the amounts recorded in the sales journals and reduced those figures by the audited amount of bad debts, including declined credit cards, checks returned for non-sufficient funds (NSF checks) and defaulted promissory notes (defaulted notes). To determine the ratio of 2.137 percent declined credit cards to recorded taxable sales, the Department reviewed the records for the week ending August 2, 2003. For the period October 1, 2001, through June 30, 2002, the Department computed a difference between recorded and reported taxable sales of $82,819,[4] which represented a percentage of understatement of 3.27 percent in comparison to reported taxable sales of $2,536,522. For the period July 1, 2003, through June 30, 2004, the Department adjusted recorded taxable sales by 2.137 percent for declined credit cards to compute audited taxable sales of $2,395,939, which exceeded reported taxable sales by $826,362, an understatement of 52.65 percent.

The Department applied the 3.27 percent of error to the amount of taxable sales reported for the third quarter 2002, since the accountant was preparing the SUTR's at that time, and it applied the higher percentage of error of 52.65 percent to reported taxable sales for the period October 1, 2002, through June 30, 2003, when petitioner was preparing its own SUTR's. The Department found that the amount of taxable sales reported for the third quarter 2004 was substantially correct. Using this procedure, the Department computed unreported taxable sales of $1,609,872, which it added to reported taxable sales of $6,456,204 to compute audited taxable sales, before adjustments for NSF checks and defaulted notes, of $8,066,076.

---

[4] For this period, the Department did not make an adjustment for declined credit cards, and the audit workpapers do not explain why that adjustment was not made. However, we note that the CPA prepared petitioner's returns for that period, and we would expect the CPA to have taken declined credit cards into account. Further, as discussed in more detail in the D&R, the amount of declined credit cards allowed in the audit computations exceeds the amount on the list of bad debts petitioner provided during the reaudit process. Therefore, we find that the issue of an adjustment for declined credit cards for this period does not warrant further investigation.

After the audit was complete, petitioner provided a list of bad debts, including declined credit card transactions, NSF checks, and defaulted notes. However, petitioner was unable to trace each uncollectible account to a specific sale for any portion of the audit period, and the Department found there was insufficient evidence to conclude that all of the listed bad debts related to sales that had been reported as taxable sales on the SUTR's. The Department conducted a test of the week ending August 25, 2003, and it computed that the total amount of NSF checks and defaulted notes represented 4.2 percent of recorded taxable sales for the week. The Department adjusted audited taxable sales by that percentage for the period October 1, 2001, through June 30, 2004 (no adjustment was made for the third quarter 2004 because the Department concluded that reported taxable sales were substantially accurate for that quarter). The Department computed audited taxable sales of $7,746,793 for the portion of the audit period through June 30, 2004, which exceeded the amount reported for that period by $1,290,589, the amount in dispute.

Petitioner contends the audited amount of bad debts should be increased based on the schedule it provided after the audit was complete. Petitioner asserts the amounts of taxable sales recorded in the sales journal should be reduced by the full amount of bad debts shown on that schedule of $1,129,509, including $750,167 for defaulted notes, $296,668 for NSF checks, and $82,674 for declined credit cards. Petitioner scheduled the amounts of defaulted notes from computer print-outs in its records that listed the amounts due on each defaulted note and the name and address of each customer. It used bank records to establish the total amounts of NSF checks, and the source of the listed amounts of declined credit cards is not identified. At the appeals conference, we offered petitioner the opportunity to conduct a test similar to the Department's test of the week ending August 25, 2003, mentioned above, tracing the defaulted notes and NSF checks to specific sales. Petitioner declined to do so, stating it would be a monumental task.

We first note that the Department has used the best available records to establish petitioner's audited sales. Petitioner has provided three types of summary records that substantially reconcile, the P&L's, the bank deposits, and the sales journals. The difference between recorded and reported total sales is $1,365,941. Since petitioner has not provided sufficient evidence to reliably document that any portion of that difference represents gross receipts that were not subject to tax, it would have been appropriate for the Department to presume that the entire difference was subject to tax. Instead, since the Department used recorded *taxable* sales to establish audited taxable sales, it in effect accepted that the amounts petitioner had recorded as nontaxable or exempt were actually not subject to tax. The Department found the recorded amounts of exempt sales in interstate commerce and nontaxable sales for resale reasonable because petitioner did make sales from studios located out of state, and petitioner provided some resale certificates. To establish the audited amount of taxable sales, the Department has reduced the recorded amount by an audited amount of bad debts, and it has computed an audited understatement of reported taxable sales of $1,290,589. We find the similarity between that figure and the difference between recorded and reported total sales of $1,365,941 to be secondary support for the accuracy of the audit findings.

With respect to its contention that a greater allowance should be made for bad debts, petitioner has not provided evidence that any of the bad debts were charged off for income tax purposes or in accordance with general accounting principles. While the Department should have required such proof before allowing *any* bad debt allowances, it did allow bad debts based on the test described above. Furthermore, the Department used a reasonable approach to estimate the amounts of recorded taxable sales that were in fact uncollectible. In addition to the fact that there is no evidence the bad debts were charged off, petitioner's schedule of bad debts is not sufficient to warrant an increase in the audited amount of bad debts because there are no records to show that the scheduled amounts correspond to sales that have been reported to the Board as taxable or included as taxable in the determination. Also, petitioner has provided no records of its attempts to collect the bad debts, and there is no certainty that the amounts shown on petitioner's schedule are net of subsequent collections. Furthermore, before we could recommend further bad debt allowances, petitioner would have to establish that the amount of bad debts it suffered, which satisfied the statutory requirements for a bad debt deduction, exceeded the bad debt allowance already given petitioner by the Department. We find there is no basis for increasing the audited amount of bad debts.

In the reaudit, the amount of tax due for the amnesty-eligible period has been reduced to $10,900. Petitioner has paid $12,768.79 against the amnesty returns (on which petitioner reported tax due of $38,565.00) which is sufficient to pay the entire amount of tax and a portion of the interest due for the amnesty-eligible period. Petitioner has claimed a refund of amounts paid on amnesty returns. For the reasons explained above, we find no further adjustments are warranted to the amount of tax due, and that petitioner has not overpaid the tax due. Therefore, we recommend that the claim for refund be denied.

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

The Department applied the 10-percent negligence penalty because petitioner's records were inadequate for sales and use tax purposes, and the audited understatement was substantial. Petitioner stated at the appeals conference that it protests the negligence penalty, but it did not provide a specific reason.

Petitioner provided no records for four of the 12 quarters covered by the audit and provided limited records for the remainder of the audit period. Further, recorded taxable sales exceeded reported amounts by more than $1 million, and the understatement of $1,290,589 represents an error rate of 20 percent ($1,290,589 ÷ $6,456,204). We find that the failure to maintain complete records, the failure to report recorded taxable sales of more than $1 million, and the failure to report 20 percent of its taxable sales are all evidence that petitioner did not exercise due care in recordkeeping and reporting. Accordingly, we find that the understatement was the result of negligence, and the penalty was properly applied.

AMNESTY

The amnesty interest penalty will not be applied in this case because petitioner filed an application for amnesty, filed amnesty returns reporting all the amnesty-eligible tax due (and more), and entered into a qualifying installment plan.

OTHER DEVELOPMENTS

None.

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