

CALIFORNIA STATE BOARD OF EQUALIZATION
APPEALS DIVISION SUMMARY FOR BOARD HEARING

In the Matter of the Petition for Redetermination)
Under the Sales and Use Tax Law of:)
ERITECH INTERNATIONAL, INC.) Account Number: SR AC 101-112916
Petitioner) Case ID 469541
Glendale, Los Angeles County

Type of Business: Internet retailer of computers and digital cameras

Audit period: 07/01/04 – 03/31/08

<u>Item</u>	<u>Disputed Amount</u>
Disallowed claimed nontaxable sales	\$ 249,215
Unreported sales	\$1,061,920
Measure of excess district tax reimbursement	\$ 186,160
Negligence penalty	\$ 10,719

	<u>Tax</u>	<u>Penalty</u>
As determined:	\$131,900.50	\$13,190.12
Adjustment - Sales and Use Tax Department	- 24,549.29	- 2,454.97
- Appeals Division	- 160.42	- 16.04
Proposed redetermination, protested	<u>\$107,190.79</u>	<u>\$10,719.11</u>
Proposed tax redetermination	\$107,190.79	
Interest through 3/31/11	40,256.82	
Negligence penalty	<u>10,719.11</u>	
Total tax, interest, and penalty	\$158,166.72	
Payments	- 34,500.00	
Balance Due	<u>\$123,666.72</u>	
Monthly interest beginning 4/1/11	<u>\$ 424.03</u>	

UNRESOLVED ISSUES

Issue 1: Whether adjustments are warranted to the audited amounts of disallowed claimed nontaxable sales, unreported sales, or unreported excess district tax reimbursement. We recommend no further adjustment.

Petitioner sells new and refurbished computers, digital cameras, peripheral equipment, and accessories through its own website and eBay. Although petitioner recorded its sales using computer

1 software, the amounts reported on sales and use tax returns were based on the amounts of sales totaled
2 on two adding machine tapes for each month, one for taxable sales and one for nontaxable sales
3 (including both nontaxable sales for resale and exempt sales in interstate commerce). Petitioner told
4 the Sales and Use Tax Department (Department) it was unable to provide electronic records of its sales
5 to support reported amounts because its computer system had crashed. The Department and petitioner
6 agreed the Department would examine petitioner's sales for a test period of three months, one month
7 from each of the three years in the audit period, April 2005, November 2006, and July 2007.

8 In its test of claimed nontaxable sales, the Department found that all of petitioner's claimed
9 exempt sales in interstate commerce were supported by shipping documents. However, it questioned
10 34 claimed nontaxable sales for resale because petitioner did not provide resale certificates. After
11 petitioner declined the opportunity to send XYZ letters, the Department searched the Board's records
12 and allowed claimed nontaxable sales to customers who held valid seller's permits and were in the
13 business of selling the type of property purchased from petitioner. The Department disallowed the
14 remainder of the questioned sales for resale. The Department noted that 13 of the questioned sales for
15 resale were drop shipments to consumers in California on behalf of out-of-state retailers who did not
16 hold California seller's permits and were not registered to collect California use tax. For those
17 transactions, the Department added a markup of 10 percent to the selling price petitioner charged its
18 customers and included that additional amount in the disallowed claimed nontaxable sales. (See Cal.
19 Code of Regs., tit. 18, § 1706, subd. (c)(2).) After the audit, petitioner provided two resale certificates
20 it had not provided previously, and the Department adjusted the disallowed amount accordingly in a
21 reaudit. In the reaudit, the total amount of disallowed claimed nontaxable sales for the three-month
22 test period was \$18,121. The Department computed a percentage of error for the test period of
23 0.64 percent, which it applied to claimed nontaxable sales to compute the amount disallowed for the
24 audit period of \$249,215.

25 To evaluate the accuracy of the adding machine tapes petitioner used to report taxable sales, the
26 Department examined them, together with the corresponding sales invoices and the UPS and FedEx
27 shipping reports, for the test months. The Department found 48 shipments to California customers on
28 the shipping reports that were not reflected on the adding machine tapes. Petitioner provided copies of

1 sales invoices for only 36 of the 48 questioned transactions, and, with only one exception, those
2 invoices showed that petitioner had collected sales tax reimbursement from its customers. The one
3 exception was a sale to the University of California, Irvine, and a copy of the same invoice provided to
4 the Department by the customer did show tax reimbursement. Petitioner provided no explanation why
5 the 48 questioned transactions had not been included on the adding machine tape used to report taxable
6 sales. To establish the selling prices for the 12 sales for which petitioner did not provide invoices, the
7 Department used the value declared for shipping, where available, or an average selling price
8 computed using the known selling prices. After the audit, petitioner provided evidence that two of the
9 48 transactions were nontaxable sales for resale, two were shipments to fill orders that had been billed
10 previously, and three were shipments by employees for personal business. The Department adjusted
11 the amount of unreported taxable sales accordingly. After those adjustments in the reaudit, the total
12 amount of unreported taxable sales for the test period was \$49,781. The Department computed a
13 98.22 percent of error, which it applied to reported taxable sales to compute \$1,061,920 unreported for
14 the audit period.

15 When it examined the invoices petitioner provided for the questioned transactions in the test
16 period, the Department noted that petitioner billed sales tax reimbursement at 8.25 percent, a rate that
17 included Los Angeles County district taxes, even if the property sold was delivered outside Los
18 Angeles County. The Department concluded that the district tax reimbursement collected by petitioner
19 with respect to deliveries outside Los Angeles County represented excess tax reimbursement.¹ The
20 Department computed that petitioner had collected excess district tax reimbursement of \$42,203 during
21 the test period, and it compared that figure to unreported taxable sales for the test period to compute an
22 error rate of 83.27 percent. It then applied that percentage to reported taxable sales to determine the
23 amount for the audit period. We noted in the D&R that the percentage of excess district tax
24 reimbursement in unreported sales should have been applied to audited *unreported* taxable sales to
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26 ¹ Petitioner was not engaged in business in districts outside Los Angeles County. Although it could have voluntarily
27 collected district use tax on its sales of property delivered into other districts, petitioner failed to allocate any of the sales
28 tax at issue to the appropriate districts. In the absence of any efficient method for the Department to allocate the excess
district tax reimbursement to the appropriate districts, the Department allocated the excess district tax reimbursement to the
State general fund.

1 establish unreported excess district tax reimbursement for the audit period, since petitioner had already
2 reported the Los Angeles County district tax on 100 percent of its reported taxable sales. After the
3 adjustment recommended in the D&R, the audited measure of unreported excess district tax
4 reimbursement for the audit period is \$186,160.

5 Petitioner contends that adjustments are warranted to these three audit items because the three-
6 month test period is not representative of the entire audit period. Petitioner states that, after it received
7 the original audit, it discovered significant errors in calculations and in characterizing its data made by
8 the consultant it had hired to compile information for the audit. Petitioner asserts that it decided to
9 reconstruct taxable sales for two test periods, one before and one after the original test months, and it
10 found only a minimal error rate. On that basis, petitioner states that the audit understatements are
11 excessive and asserts that a second reaudit should be performed using different test months. Also,
12 petitioner claims that the amount of disallowed claimed nontaxable sales should be based on an actual
13 review of its sales during the audit period to the four companies for which it made drop-shipments
14 during the test period, rather than by applying the percentage of error in claimed nontaxable sales that
15 the Department computed for the test period.

16 We first note that petitioner has provided no evidence of any unusual circumstances during the
17 test period and has offered no adequate basis for its claim that the test results should be rejected. We
18 further note that the Department tested one month in each year of the audit period, which is considered
19 a more effective testing method than one test of a longer period. (See Sales and Use Tax Department
20 Audit Manual, § 0405.20, subd. (c).) Further, the Department examined more than 2,000 sales in the
21 three-month test period. Moreover, the errors found in the test months were relatively consistent. For
22 example, in the test of recorded taxable sales, the Department found 16 unrecorded taxable sales in
23 April 1005, 13 in November 2006, and 13 in July 2007. We are not persuaded by petitioner's claim
24 that these errors were related to the consultant's errors in calculations and characterizing data since the
25 errors were found by a comparison of the adding machine tapes used to report taxable sales and the
26 shipping reports for UPS and FedEx, not by review of data separately prepared by the consultant.

27 Regarding petitioner's argument that it has conducted a test of different periods that shows only
28 minimal understatement, we note that petitioner has provided no details about the new test.

1 Furthermore, we have significant concerns about the validity of further testing based on reconstructed
2 taxable sales because the Department found evidence that the copies of sales invoices in petitioner's
3 records were not reliable (such as the previously noted difference between the sales invoice provided
4 by petitioner and the copy of the same sales invoice provided by the customer, University of
5 California, Irvine). We find that the Department has conducted sufficient testing and petitioner has not
6 provided any evidence that the months tested were not representative of the audit period. Therefore,
7 we recommend no expansion of the audit tests for any of the three audit items.

8 With respect to petitioner's claim that the amount of disallowed claimed nontaxable sales
9 should be based on an actual review of its sales during the audit period to the four companies for which
10 it made drop-shipments during the test period rather than by applying the percentage of error in
11 claimed nontaxable sales computed for the test period, we first note that those drop shipments were not
12 the only errors identified in the claimed nontaxable sales. The drop shipments represented about
13 84 percent of the errors, but about 16 percent of the errors were sales to California consumers that
14 petitioner had erroneously claimed as nontaxable. In addition, there is no certainty that those four
15 companies were the only companies for which petitioner made drop shipments throughout the audit
16 period. Accordingly, we conclude that petitioner's suggested method of establishing disallowed
17 claimed nontaxable sales would almost certainly not capture all of the sales erroneously claimed as
18 nontaxable during the audit period. Consequently, we recommend no changes to the testing
19 procedures for claimed nontaxable sales.

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

21 The Department imposed the negligence penalty because petitioner failed to maintain adequate
22 records and because petitioner failed to record and report nearly half of its taxable sales. The
23 Department also noted that there is evidence petitioner included sales tax reimbursement on invoices
24 sent to its customers but maintained copies of sales invoices that did not show sales tax reimbursement.
25 Petitioner has not specifically protested the negligence penalty.

26 Petitioner provided inadequate records, stating that its electronic files were not available
27 because its computer had crashed. As a retailer of computers, petitioner should have been aware of the
28 necessity to maintain backup files for important records, and it is possible that petitioner regarded its

1 adding machine tapes as a backup record of sales. However, those adding machine tapes included only
2 about half of the sales for which petitioner had collected sales tax reimbursement. We find petitioner's
3 failure to record a substantial portion of its taxable sales is evidence of a lack of due care in
4 maintaining records. In addition, we note that the audited understatement of reported taxable measure
5 of \$1,497,295 (\$1,061,920 + \$249,215 + \$186,160) represents an understatement of 138 percent in
6 comparison to reported taxable sales of \$1,081,164. We find that the lack of adequate records and
7 substantial understatement are strong evidence of negligence, and the penalty was properly applied.

8 **OTHER DEVELOPMENTS**

9 None.

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