

1 CALIFORNIA STATE BOARD OF EQUALIZATION

2 APPEALS DIVISION BOARD HEARING SUMMARY

3 In the Matter of the Petition for Redetermination)
 4 Under the Sales and Use Tax Law of:)
 5 MARK JEFFREY FREED, dba Tires buy Mark) Account Number SR AC 13-887076
 6 Petitioner) Case ID 554113
 7 _____) Canoga Park, Los Angeles County

8 Type of Business: Sales of tires and batteries

9 Audit period: 01/01/06 – 12/31/08

<u>Item</u>	<u>Disputed Amount</u>	
11 Unreported taxable sales established on a markup basis	\$798,399 ¹	
12 Fraud penalty	\$ 93,981	
	<u>Tax²</u>	<u>Penalty</u>
13 As determined and proposed to be redetermined	\$398,062.58	\$102,836.29
14 Less concurred	<u>- 313,116.19</u>	<u>- 8,855.03</u>
15 Balance, protested	<u>\$ 84,946.39</u>	<u>\$ 93,981.26</u>
16 Proposed tax redetermination	\$398,062.58	
17 Interest through 07/31/13	177,944.05	
18 Fraud penalty	93,981.26	
19 Penalty for failure to remit collected tax	<u>8,855.03</u>	
20 Total tax, interest, and penalty	\$678,842.92	
21 Payments	<u>- 60,902.28</u>	
22 Balance Due	<u>\$617,940.64</u>	
23 Monthly interest beginning 08/01/13	<u>\$ 1,685.80</u>	

21 UNRESOLVED ISSUES

22 **Issue 1:** Whether adjustments are warranted to the understatement of reported taxable sales
 23 established on a markup basis. We find no adjustment is warranted.
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25 ¹ The amount of unreported taxable sales is net of an adjustment of \$114,046 for the cost of tax-paid purchases resold, as
 26 described under "Resolved Issues."

27 ² There will be a reduction in tax as a result of the revision of our position regarding the application of tax to wheel weights
 28 and valve stems, as explained under "Resolved Issues." Because of time constraints related to the upcoming Board hearing,
 the Department has not completed a reaudit. Therefore, the figures in the table have not been revised. We estimate that the
 reduction in tax will be about \$19,078 [(\$117,207 + \$114,046) x 8.25%], with corresponding reductions to penalty and
 interest.

1 Petitioner has been a retailer of tires, wheels, batteries, and accessories since May 1992. For
2 audit, petitioner provided federal income tax returns; a summary of purchases by vendor for the audit
3 period; a partial set of purchase invoices; sales and use tax return worksheets for the second quarter
4 2006 (2Q06), 3Q07, and 4Q08; and, for 4Q08 only, sales invoices, sales summary sheets, and bank
5 statements.

6 The Sales and Use Tax Department (Department) considered petitioner's records incomplete
7 and established audited taxable sales on a markup basis. The Department used a shelf test to compute
8 audited markups of 13.97 percent for sales for resale and 18.49 percent for retail sales. To establish
9 the audited cost of taxable sales, the Department used the cost of goods sold recorded on the federal
10 tax returns, which it reduced for: 1) the audited cost of consumable supplies, 2) the audited cost of
11 outside repair labor that had been recorded as cost of goods sold, and 3) the cost of recorded sales for
12 resale (net of the amounts that were disallowed), computed using the 13.97 percent markup. The
13 Department computed that the taxable sales established by markup exceeded reported taxable sales by
14 \$4,707,792. However, the Department also noted that part of the understatement was the result of
15 petitioner's failure to report all of the taxable sales it had recorded and petitioner's overstatement in the
16 amount of recorded nontaxable sales for resale. Accordingly, the Department used information from
17 4Q08, the only quarter for which petitioner provided reasonably complete sales records, to compute
18 percentages that it applied to reported total sales and to claimed sales for resale to establish an
19 understatement of reported taxable sales of \$3,669,095 and disallowed claimed sales for resale of
20 \$126,252.³ The Department then decided to segregate the total understatement of \$4,707,792,
21 established on a markup basis, into the amounts that were developed using petitioner's records, and the
22 remainder of the difference that was related solely to the markup computations. Accordingly, the
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25 ³ Although the computation of the amount of unreported taxable sales based on the Department's review of the 4Q08 is not
26 explained in the D&R, we include a general description of the audit process here. The Department reviewed the sales slips
27 for the 4Q08 and computed that, for that quarter, petitioner had recorded 78.03 percent of his sales as taxable. It applied
28 that percentage to reported total sales of \$11,268,014 to compute taxable sales of \$8,792,431, which it compared to reported
taxable sales of \$5,123,335 to compute an understatement of \$3,669,096. For 4Q08, the Department also computed that
recorded nontaxable sales for resale represented 16.33 percent of recorded total sales. The Department applied
16.33 percent to reported total sales to compute recorded sales for resale of \$1,840,067. In a test of November 2008, the
Department found that petitioner's recorded nontaxable sales for resale were overstated by 6.86 percent, and it applied that
percentage to compute an overstatement of claimed sales for resale of \$126,252 (\$1,840,067 x 6.86%).

1 Department deducted the understatement based on petitioner's records for 4Q08 of \$3,669,095 and
2 \$126,252 from \$4,707,792 to compute the amount of unreported taxable sales related solely to the
3 markup computations of \$912,445, which petitioner disputes.

4 Petitioner contends that the retail markup is incorrect because the Department failed to include
5 the costs of valve stems and tire weights in the costs used in the computation of the markup, asserting
6 that valve stems and tire weights are sold with each tire. Petitioner states that his true markup is
7 between 10 and 11 percent because he must provide a valve stem and wheel weights with each tire he
8 sells and installs. As support, petitioner has provided copies of sales invoices which show the sale and
9 installation of a single tire, a purchase invoice which shows purchases of various tires, and a
10 photograph of a sign allegedly posted at the business during the audit period, which states that the
11 valve stem is included in the price of the tire.

12 It is undisputed that petitioner charged a single price for each tire he sold, and we now conclude
13 that the vast majority of the valve stems and wheel weights were sold with the tires, and were not
14 consumable supplies, as explained under "Resolved Issues." However, that conclusion does not
15 warrant a revision in the audited markups because the markups were applied to the cost of the goods
16 sold, net of the cost of consumable supplies, which, as previously computed by the Department,
17 included the cost of valve stems and wheel weights. In other words, if the cost of valve stems and
18 wheel weights were included in the computation of the audited markups, the cost of goods sold to
19 which the markups are applied would be increased by the cost of those purchases. Thus, a lower
20 markup would be applied to a greater cost of goods sold, with no change in the end result. Further, we
21 have reviewed the shelf test, and we have identified no apparent errors. Also, we find the shelf test is
22 sufficiently complete to be representative. Consequently, we find no adjustment is warranted to the
23 audited markup.

24 **Issue 2:** Whether the Department has established fraud by clear and convincing evidence.⁴ We
25 find that the Department has.

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28 ⁴ Without regard to whether the finding of fraud is upheld, the Notice of Determination was timely issued for the entire
audit period under the 3-year statute of limitations (Rev. and Tax. Code § 6487, subd. (a)).

1 The Department imposed a fraud penalty of \$93,981.26 on an understatement of tax of
2 \$375,925.02 (\$398,062.58 total understatement of tax less \$22,137.56, on which it imposed a
3 40 percent penalty for failure to remit sales tax reimbursement collected). The Department found that
4 petitioner knowingly collected sales tax reimbursement from his customers, and exhibited his
5 knowledge of the proper collection of tax by collecting tax only on taxable sales. The Department also
6 concluded that petitioner had consistently and systematically failed to report a material portion of his
7 taxable sales to the State for a prolonged time period, noting that a fraud penalty was also applied to
8 petitioner's prior audit, for a period beginning July 1, 2002.

9 Petitioner disputes the fraud penalty, asserting that he had no specific intent to evade or avoid
10 sales tax. Petitioner reasons that, if he were truly fraudulent, he would not have provided the
11 Department with records for 4Q08, which the Department used as the basis for the bulk of the audit
12 liability. Moreover, regarding the fraud penalty applied to the prior period, petitioner states that he
13 reached a settlement agreement with the Board in which the fraud penalty for that period was reduced
14 to a negligence penalty. Petitioner asserts that the reduction of the penalty in the prior audit is
15 evidence that the Board does not believe petitioner was fraudulent in the prior period, and he implies
16 that the same change, from a fraud penalty to negligence penalty, is warranted here.

17 The Department's review of the sales records for 4Q08 disclosed that petitioner collected sales
18 tax reimbursement of \$61,803 but reported tax of only \$39,666. Thus, he failed to report more than
19 one-third of his recorded taxable sales. The Department used the percentages established in its review
20 of petitioner's records for 4Q08 to establish an understatement of reported taxable sales of \$3,669,095.
21 Petitioner concedes that substantial understatement which represents, in effect, a difference between
22 recorded and reported taxable sales.⁵ Petitioner has not explained why he failed to report taxable sales
23 over \$3.5 million that were recorded in his own records. We note that petitioner actively worked at the
24 business, prepared sales invoices, and collected sales revenue, including sales tax reimbursement. We
25 find that his failure to report substantial amounts of taxable sales he had recorded is clear and

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27 ⁵ Essentially, the amount of taxable sales computed using the percentage of recorded taxable to total sales for 4Q08 is the
28 best indicator of what recorded taxable sales were for the remainder of the audit period, for which petitioner did not provide records.

1 convincing evidence of fraud, particularly since the errors found in the current audit are identical to
2 those found in the prior audit. In addition, we find that the substantial total understatement of
3 \$4,825,000, which represents an error ratio of 94 percent in comparison to reported taxable sales of
4 \$5,123,335, is additional evidence of fraud, particularly since it is evidence of a continued pattern of
5 substantial underreporting that was noted in the prior audit. We find petitioner's assertion that he had
6 no specific intent to evade tax but simply reported incorrectly to be unpersuasive in light of the facts of
7 this case. Similarly, we find that the fact petitioner provided records for one quarter of a 12-quarter
8 audit period is not a viable defense against fraud. In addition, we find that the settlement of the prior
9 period is irrelevant to our analysis of the fraud penalty here, since the settlement agreement contains
10 language binding both parties to concur that the settlement agreement does not apply to periods before
11 or after the period covered by the settlement agreement. Thus, we find that none of petitioner's
12 arguments alters our conclusion that the Department has established fraud by clear and convincing
13 evidence, and that the fraud penalty was properly applied.

14 **RESOLVED ISSUES**

15 In his petition for redetermination, petitioner protested the entire liability. However, at the
16 appeals conference, petitioner conceded the liabilities established for disallowed sales for resale of
17 \$126,252 and for unreported taxable sales, computed using the percentage of taxable to total sales
18 established in the Department's review of the 4Q08, of \$3,669,095. In addition, petitioner conceded
19 the 40 percent penalty for failure to remit sales tax reimbursement collected of \$8,855.03 (which was
20 computed on \$22,137.56, the amount of sales tax reimbursement compiled from petitioner's sales
21 records for 4Q08 in excess of the amount of sales tax reported for that quarter). Accordingly, those
22 issues are resolved.

23 In the D&R, we concluded that petitioner was the consumer of the valve stems and wheel
24 weights because we understood that petitioner provided valve stems and wheel weights in the course of
25 performing services that were optional for its customers (tire mounting and balancing), and therefore
26 not part of the sale of the tire. Upon further consideration of this issue during the preparation for the
27 Board hearing, we found that petitioner made no separate charge for mounting or balancing, and that
28 such services were part of the sale of the tire. Therefore we now find that petitioner was the retailer of

1 the valve stems and wheel weights that were included in his sales of tires. Thus, the amount of tax due
2 is the sales tax computed based on the selling price of the tire.

3 Accordingly, we find that petitioner was not the consumer of the valve stems and wheel
4 weights that were included with the sales of tires. We also find that there would be a minor amount of
5 installation and balancing that did not involve the sale of a tire, and that petitioner would be the
6 consumer of valve stems and wheel weights in those situations. In addition, there would be a minor
7 amount of consumable shop supplies other than valve stems and wheel weights. The Department has
8 estimated the percentage of consumable supplies at five percent of total supplies purchased, and we
9 find that estimate reasonable. Based on this finding, we recommend that the unreported cost of
10 consumable supplies of \$117,208 be deleted from the determination. We also recommend that the
11 determination be adjusted for tax-paid purchases resold of \$114,046.⁶

12 **OTHER MATTERS**

13 None.

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15 Summary prepared by Deborah A. Cumins, Business Taxes Specialist III
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27 ⁶ The Department has computed the amount of tax-paid purchases resold as follows: Total supplies purchased of \$243,425
28 x 95 percent = \$231,254. Of that amount, \$117,208 was purchased without tax. Thus, the amount of tax-paid purchases
resold is \$114,046 (\$231,254 - \$117,208).

MARKUP TABLE

Percentage of taxable vs. nontaxable purchases	100%
Mark-up percentages developed	18.49% - taxable sales 13.97% - sales for resale
Self-consumption allowed in dollars	None*
Pilferage allowed in dollars	None*

* During the audit, and again at the conference (after we had explained the effect of allowances for self-consumption), petitioner stated that he did not withdraw merchandise from inventory for self-consumption or experience any theft of taxable merchandise.