

1 CALIFORNIA STATE BOARD OF EQUALIZATION

2 APPEALS DIVISION SUMMARY FOR BOARD HEARING

3 In the Matter of the Claim for Refund)
4 Under the Sales and Use Tax Law of:)

5 J's TIRES, INC.)

6 Claimant)

Account Number: SR GH 100-121536

Case ID 301642

Santa Maria, Santa Barbara County

7 Type of Business: Sales of tires and related parts

8 Claim Period: 04/01/00 – 03/31/03

9 Item Claimed Refund10 Fraud penalties \$17,136.02¹

11 Claimant filed five claims for refund for overpayments on three notices of determination issued
12 for the audit of the period April 1, 2000, through March 31, 2003. Although claimant originally
13 claimed overpayments of tax, it now disputes only the fraud penalties. The total amount of fraud
14 penalties paid is \$18,868.94,² but only one of the five claims for refund is timely³ for any portion of
15 the payments for fraud penalties. The Sales and Use Tax Department (Department) has concluded, and
16 claimant agrees, that its claim dated May 7, 2008, is timely for payments of \$17,136.02 applied to the
17 fraud penalty within the six preceding months.

18 UNRESOLVED ISSUE

19 **Issue:** Whether the Department has established by clear and convincing evidence that the
20 understatement was due to fraud or intent to evade the tax. We find that it has.

21 Claimant sells and installs vehicle tires and related parts and makes other vehicle repairs.

23 ¹ The Department conducted an audit of the period April 1, 2000, through March 31, 2003. It issued three notices of
24 determination, each of which was issued within the three-year statute of limitations. Accordingly, if the fraud penalties are
not upheld, there will be no reduction of the amount of tax determined as a result of the statute of limitations.

25 ² The penalties were \$4,649.52 for the period April 1, 2000, through September 30, 2000, \$3,052.78 for the period
October 1, 2000, through March 31, 2001, and \$11,166.64 for the period April 1, 2001, through March 31, 2003

26 ³ Revenue and Taxation Code section 6902 provides that a claim for refund is timely if filed within three years from the last
27 day of the month following the close of the quarterly period for which the overpayment was made, or, with respect to
determinations, within six months after the date the determination became final or six months from the date of payment,
whichever is later. In this case, petitioner filed claims for refund dated February 22, 2005, October 6, 2006, March 13,
2007, November 9, 2007, and May 7, 2008. However, all payments toward the fraud penalties were made on and after
28 May 6, 2008. Thus, the May 7, 2008, claim for refund is the only one that is timely for payments of the fraud penalty, and
the total amount applied to fraud penalties during the six months prior to that date was \$17,136.02.

1 Claimant was previously operated by the corporate president as a sole proprietor, and the business was
2 incorporated on March 7, 1986. The business was audited once before, for the period April 1, 1994,
3 through December 31, 1996, but the audit did not result in a deficiency. When the Department
4 conducted that audit, it became aware that the business had incorporated and noted that fact on the
5 back of the audit report. However, the business entity was not changed in the Board's records until the
6 audit at issue here was initiated, when a new seller's permit was issued for claimant with an effective
7 start-up date of April 1, 1986.

8 The Department received an anonymous call on January 7, 2003, in which the informant stated
9 that, if customers paid cash, claimant frequently sold tires and related parts to retail customers at
10 wholesale prices, without collecting sales tax reimbursement. The informant stated that claimant did
11 not issue sales receipts for these sales, and it did not record the name of the actual purchaser. Instead,
12 claimant recorded the sales as sales for resale to different customers to whom claimant routinely made
13 valid sales for resale. The Department examined claimant's invoices for September 2002, and then
14 expanded the test to include the entire third quarter 2002. For that quarter, the Department found that
15 claimant had recorded 115 sales for resale, totaling \$61,153, to 27 customers. The Department sent
16 XYZ letters to each of those 27 customers, all of whom responded. Nine of the 27 customers verified
17 that the 13 recorded sales for resale had in fact been made to them. The remaining 18 customers, for
18 whom claimant recorded 102 sales, indicated that, for 78 of the 102 sales, they either did not make the
19 purchases detailed in the XYZ letters or could not find a record of the transactions. The Department
20 disallowed those 78 sales, which totaled \$49,173, and found that the balance of \$11,980 (\$61,153 –
21 \$49,173) represented valid nontaxable sales for resale. Since the claimed amount of sales for resale
22 was \$65,937, rather than \$61,153, the Department concluded that the claimed amounts did not
23 correspond to recorded nontaxable sales and decided to establish the allowed amount of nontaxable
24 sales for resale using the percentage of valid nontaxable sales to reported total sales of 2.4638 percent
25 ($\$11,980 \div \$486,233$). The Department applied that percentage to reported total sales of \$5,175,033 to
26 compute the allowed amount of sales for resale of \$127,503, while claimant deducted sales for resale
27 of \$1,112,302, which was \$984,799 more than the audited allowable resales. The Department found
28 claimant knowingly falsified its records, with intent to evade payment of sales tax due on retail sales.

1 Thus, the Department concluded that the overstatement of claimed sales for resale was the result of
2 fraud and imposed 25 percent fraud penalties.

3 Claimant argues that the Department has not met its burden to establish, by clear and
4 convincing evidence, that claimant's underreporting was due to fraud or intent to evade tax. Claimant
5 asserts that it did not intentionally avoid tax but that it was, itself, a victim of fraud. Claimant states
6 that two of its tire installers, whose employment has since been terminated, were selling tires to family
7 and friends at wholesale prices and not charging sales tax reimbursement. The corporate president
8 states he was not aware of these actions by two employees. Claimant states that the installers' alleged
9 fraud resulted in significant financial damage to the business because the tires were sold at a 10 percent
10 markup rather than the 25 percent markup typically added to retail sales, and because claimant did not
11 receive reimbursement for the sales tax that it was required to pay to the Board. In addition, claimant
12 argues that the Department cannot rely on claimant's post-audit reporting activities as a basis for the
13 imposition of the fraud penalties. As support, claimant has provided a D&R issued regarding the
14 appeal of another (unrelated) taxpayer, which stated that post reporting period conduct does not
15 constitute an independent basis for addition of the fraud penalty. Since the Department did not rely on
16 claimant's post-reporting period conduct to assert fraud, we do not address this argument further.

17 The Department must establish fraud by clear and convincing evidence, which requires
18 evidence so clear as to leave no substantial doubt as to the truth of an assertion of fraud. Here, there is
19 no dispute that claimant had knowledge of the Sales and Use Tax Law and its recordkeeping and tax-
20 reporting obligations (the corporate president had operated the business since 1982, when the business
21 began as a sole proprietorship). Claimant's knowledge of the Sales and Use Tax Law is demonstrated
22 by its consistent filing of sales and use tax returns and its collection of sales tax reimbursement on
23 sales recorded as taxable during the audit period. Also, a prior audit of the business when it was
24 operated as a sole proprietorship resulted in no change to reported amounts. Moreover, claimant's
25 records were substantially correct and complete, with no errors identified by the Department other than
26 the disallowed claimed sales for resale at issue.

27 Despite this knowledge and experience, claimant falsely recorded retail sales as sales for resale
28 to customers other than the true purchasers. Claimant then claimed those falsely recorded sales as

1 nontaxable sales for resale, thus evading the tax on those gross receipts. Specifically, based on a test
2 of the third quarter 2002, the Department disallowed \$984,799 of claimant's total claimed sales for
3 resale, an error rate of 88.54 percent in comparison to claimed sales for resale of \$1,112,302, and an
4 error rate of 33.56 percent when compared to reported taxable sales of \$2,934,359. The Department
5 found these errors to be consistent throughout the audit period. Further, claimant does not now dispute
6 that the disallowed claimed sales for resale were in fact sales to retail customers that had been falsely
7 recorded as sales for resale. Instead, claimant contends that two former employees, independently and
8 without claimant's knowledge, falsified the sales records in order to make sales of tires and related
9 parts to friends and family members at wholesales prices and without charging sales tax
10 reimbursement. The only evidence claimant has presented to support this contention is a declaration
11 by the corporate president, dated more than five years after the end of the audit period.

12 Claimant has not provided an insurance claim or any other evidence to substantiate the losses it
13 allegedly incurred as a result of the employees' actions. Further, claimant has not explained how it
14 discovered the employees' "unauthorized activities" in the latter part of 2002 or when, in relation to
15 the discovery, these employees were actually fired. More importantly, the corporate president did not
16 appear at the appeals conference, and we thus were not given the opportunity to ask questions and
17 assess the credibility of his assertion that two employees were solely responsible for the falsification of
18 records. Also, we find it unlikely that two individuals would have so many friends and family
19 members who needed the merchandise claimant sells. In that regard, in the third quarter 2002 only,
20 there were at least 78 falsified sales. For all these reasons, we are not convinced by the corporate
21 president's declaration, which is not supported by any other objective documentation, that claimant
22 was unaware of the employees' falsifying of records.

23 Even if we were to accept that claimant's employees intentionally, and without claimant's
24 knowledge, made the disallowed claimed sales for resale for purposes of benefitting their family and
25 friends, we would still conclude the fraud penalty applies. The fraud of the employees would be
26 imputed to claimant as the employer, even if claimant were unaware of the fraud, unless claimant
27 suffered financially as a result of its employees' wrongdoing. Here, there has been no allegation that
28 claimants' employees embezzled funds or products, or financially benefitted from the transactions at

1 issue for their own financial gain. Further, the Department asserts that claimant actually benefitted
2 from the wrongdoing because it was able to make sales that it otherwise would not have made, by
3 offering wholesale prices and no sales tax reimbursement to retail customers. In contrast, claimant
4 asserts that it was financially damaged because it did not make the full profit it routinely made on retail
5 sales, and it ended up having to pay sales tax for which it had not collected reimbursement from its
6 customers. We first note that claimant did make a profit, albeit not as much profit as it might have
7 otherwise received. With respect to the sales tax, claimant had to pay the sales tax only because the
8 Department discovered its erroneous reporting. The “plan” (whether fashioned by the two employees
9 or otherwise), was to *not* pay any sales tax, and for claimant to receive a markup of 10 percent. We
10 believe it likely that most or all of the sales would not have been made if the purchasers had been
11 required to pay full retail price, with tax reimbursement. Thus, based on the plan as conceived,
12 claimant received a markup of 10 percent for many or all of these sales which it would not otherwise
13 have obtained. We conclude that claimant did not suffer financially as a result, for these purposes, and
14 claimant has not provided any evidence to the contrary. Accordingly, we conclude that even if
15 claimant were unaware of the employees’ actions, claimant benefitted from those actions, and the fraud
16 penalties have been properly applied.

17 **OTHER DEVELOPMENTS**

18 None.

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22 Summary prepared by Deborah A. Cumins, Business Taxes Specialist III
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EVIDENCE OF FRAUD RELIED ON BY DEPARTMENT

1.	Substantial deficiency, which cannot be explained as due to negligence or honest mistake.	Yes
2.	More than one set of records.	No
3.	Falsified records.	Yes
4.	Substantial discrepancies between recorded and reported amounts for which there is no valid explanation.	No*
5.	Prior audit of claimant thus indicating that claimant was knowledgeable about the requirements of law.	Yes
6.	Tax charged to customers but not reported.	No
7.	Transfers of amounts of unpaid tax from the tax accrual account to another income account.	No
8.	Consistent substantial underreporting.	Yes

* Amounts of nontaxable sales recorded did not reconcile with claimed amounts, but that discrepancy was not the key factor that showed fraud. More significantly, the source documents (sales invoices) were not available to support the recorded amounts. In fact, when a customer asked petitioner to provide copies of sales invoices to verify that certain sales had been made (in order for the customer to have information to respond to an XYZ letter), petitioner declined to do so.