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:	)	
TJ'S METAL MFG., INC.	)	Account Number: SR AA 100-331088
	)	Case ID 469958
Petitioner	)	Lynwood, Los Angeles County

Type of Business: Manufacturer of metal products

Audit period: 1/1/04 – 6/30/07

Item	Disputed Amounts
1. Unreported purchases of assets	$ 110,929
2. Unreported purchases of supplies	$ 196,999
3. Unreported taxable sales	$8,850,949
4. Unclaimed bad debt deduction	$ 206,602
5. Negligence penalty	$74,133.17
6. Interest	Not specified

	Tax	Penalty
As determined	$ 755,493.76	$75,549.39
Adjustment - Sales and Use Tax Department	- 14,162.29	- 1,416.22
Proposed redetermination, protested	$ 741,331.47	$74,133.17

Proposed tax redetermination	$ 741,331.47
Interest through 2/29/12	331,942.61
Negligence penalty	74,133.17
Total tax, interest, and penalty	$1,147,407.25
Payments and offsets	- 215,128.38
Balance Due	$ 932,278.87
Monthly interest beginning 3/1/12	$3,069.52

UNRESOLVED ISSUES

Issue 1: Whether petitioner has established that any of the unreported purchases of fixed assets or supplies are not subject to use tax. We conclude that it has not.

The Sales and Use Tax Department (Department) examined petitioner's fixed asset purchases acquired during the audit period as listed on its federal income tax depreciation schedules. Petitioner could not show that it paid tax or tax reimbursement on $110,929 of the acquired assets. The

Department also examined petitioner's paid bills for 2006 and found that petitioner did not pay tax on purchases of consumable supplies from out-of-state vendors or under resale certificates issued to in-state vendors, totaling $25,847, a 126.69 percent error rate when compared to the $20,401 of recorded purchases of supplies for 2006. Applying the error rate to the recorded purchases of supplies for the balance of the audit period, the Department computed an understatement measured by $196,999. Petitioner contends that the Department improperly used a test period and error rate to project errors to the remainder of the audit period.

Block sampling is a recognized and approved audit method. Petitioner has not shown that the Department's 2006 test period for consumable supplies is not representative or that the test produced unreliable results. Nor has petitioner shown that any of the purchases of fixed assets included in the determination were tax paid or otherwise are not subject to tax. Accordingly, we recommend no adjustment.

Issue 2: Whether petitioner has established that an adjustment is warranted to the unreported taxable sales. We conclude that it has not.

The Department reconciled petitioner's recorded sales tax accrual account with its amounts of sales tax paid to the Board, noting a $730,089 discrepancy for the audit period. The Department capitalized this amount by the applicable tax rates, and established $8,850,949 as unreported taxable sales. Petitioner contends that the audited unreported taxable sales is overstated because the Department did not utilize petitioner's Accounts Receivable-Sales Tax Billed reports to determine taxable sales and did not account for petitioner's sales for resale.

Reconciliation of sales tax accrual accounts to sales tax reported is a recognized and approved audit method. We note that the Department *did* utilize petitioner's reports to determine unreported taxable sales. Petitioner has not shown that it erroneously accrued tax on any nontaxable sales for resale. Therefore, we find that no nontaxable sales for resale are included in the unreported taxable sales. Since petitioner has provided no evidence showing that the Department's methodology is unreliable, we have no basis upon which to recommend any adjustment.

Issue 3: Whether petitioner has established that an additional adjustment is warranted for unclaimed bad debt deductions. We conclude that it has not.

The Department concluded the documentation petitioner provided supports a $173,063 bad debt deduction for the audit period, but that a larger deduction is not warranted because: petitioner did not provide sales tax worksheets showing that it had previously reported the subject sales as taxable; some of the sales invoices did not include sales tax reimbursement; petitioner was still actively attempting to collect on some of the claimed bad debts; and the reports petitioner provided did not contain enough information to establish that the accounts receivable credits were related to bad debt write-offs of reported taxable sales. In its letter dated September 20, 2010, petitioner included a schedule of alleged bad debts totaling $379,665. Since the Department has already allowed $173,063 in bad debts, we understand petitioner to seek an additional allowance for bad debts of $206,602. However, petitioner has not established that it previously reported these amounts as taxable and that it legally charged off these amounts as bad debts. Accordingly, we find that petitioner is not entitled to an additional allowance for bad debts.

Issue 4: Whether petitioner was negligent. We conclude that it was negligent.

The Department imposed a 10-percent penalty for negligence based on petitioner's failure to report its sales and accurately keep records. Petitioner contends that it was not negligent and that the penalty is excessive.

Petitioner understated its taxable measure by $8,985,814, a 136 percent understatement. That level of understatement for the entire audit period is significant and constitutes strong evidence that petitioner failed to exercise the degree of care expected of an ordinary prudent businessperson in preparing its returns with a reasonable degree of accuracy. Petitioner could not explain why it failed to accurately report its sales, and could not provide records supporting most of the differences between the sales tax it accrued and the sales tax it reported to the Board. Notwithstanding this was petitioner's first audit, we believe that the level of the understatement and petitioner's failure to maintain proper records to accurately report its taxable sales justifies a finding of negligence.

Issue 5: Whether interest has been correctly calculated. We conclude that it has been.

The October 29, 2008 Notice of Determination includes accrued interest of $215,768 and interest continues to accrue on petitioner's unpaid liability. Petitioner contends that the interest charges are incorrect but has not provided any specific basis for its position. We have found no errors in the application of interest to petitioner's tax liability, and petitioner has not provided any evidence showing otherwise.

OTHER DEVELOPMENTS

None.

Summary prepared by Pete Lee, Business Taxes Specialist II