

CALIFORNIA STATE BOARD OF EQUALIZATION
APPEALS DIVISION SUMMARY FOR BOARD HEARING

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3 In the Matter of the Petition for Redetermination)
4 Under the Sales and Use Tax Law of:)
5 WAREFORCE CORP.) Account Number: SR Z EA 100-063450
6 Petitioner) Case ID 442311
7 _____) Irvine, Orange County

8 Type of Business: Sales and repair of computer equipment and supplies

9 Audit period: 04/01/03 – 03/31/07

<u>Item</u>	<u>Disputed Amount</u>
11 Disallowed claimed nontaxable sales	\$1,794,447
12 Tax as determined and proposed to be redetermined:	\$339,834.13
13 Less concurred	- 198,757.43
14 Balance, protested	<u>\$141,076.70</u>
15 Proposed tax redetermination	\$339,834.13
16 Interest	<u>94,838.88</u>
17 Total tax and interest	\$434,673.01
18 Payments (tax paid in full)	<u>- 365,013.82</u>
19 Balance Due	<u>\$ 69,695.19</u>

20 A Notice of Appeals Conference was mailed to petitioner's address of record, and the notice
21 was not returned by the Post Office. Petitioner did not respond to the notice or appear at the appeals
22 conference, which was held as scheduled. We thereafter sent petitioner a letter offering it the
23 opportunity to provide any additional arguments and evidence in writing it wished us to consider, and
24 petitioner responded that it had not received the Appeals Conference Notice. However, it also stated
25 that it had no new comments or evidence to provide. We subsequently offered petitioner a second
26 conference, but petitioner declined.

27 This matter was scheduled for Board hearing on October 20, 2010, but petitioner did not
28 respond to the Notice of Hearing. Accordingly, the Board Proceedings Division informed petitioner
that this matter would be presented to the Board for decision without oral hearing. Petitioner
subsequently requested that the matter be scheduled for hearing.

UNRESOLVED ISSUE

Issue: Whether adjustments are warranted to the amount of disallowed claimed nontaxable sales based on a stratified statistical sample. We recommend no adjustment.

Petitioner operated as a seller of computer equipment, software systems, and related supplies, and offered repair services. Petitioner provided various records for different portions of the audit period. The Sales and Use Tax Department (Department) was unable to clearly determine how petitioner compiled its sales for reporting purposes because no worksheets were attached to the sales and use tax returns for periods after 2004. However, based on a reconciliation of the California sales reports in petitioner's records and reported total sales, the Department concluded that reported total sales were substantially correct. The Department also noted that petitioner's reported taxable sales were computed using recorded amounts of accrued sales tax and the applicable tax rate.¹

The Department accepted claimed exempt sales in interstate or foreign commerce after performing a block test of such sales and finding no errors. To verify petitioner's remaining claimed nontaxable sales, the Department performed a statistical test of sales made during the period January 1, 2005, through June 30, 2006 (1Q05 through 2Q06).² The Department segregated the sales into four strata, up to \$100, \$100.01 to \$3,000, \$3,000.01 to \$20,000, and greater than \$20,000. It did not review any claimed nontaxable sales less than \$100, it reviewed all claimed nontaxable sales greater than \$20,000, and it chose random samples of claimed nontaxable sales to review from the remaining two strata. For sales from \$100.01 to \$3,000, the Department found 18 errors in its examination of 353 sample invoices, including two claimed nontaxable sales to an insurance company, one claimed nontaxable restocking charge, two claimed sales for resale, and 13 claimed nontaxable handling charges. The Department computed a percentage of error for this stratum of 2.1014 percent. For sales from \$3,000.01 to \$20,000, the Department found eight errors in its examination of 347 sample invoices, including seven claimed nontaxable sales to an insurance company and one claimed

¹ Reported taxable sales did not reconcile with recorded taxable sales because some of the recorded taxable sales were subject to the partial exemption from tax for property used in teleproduction or other postproduction services, and the recorded taxable sales included lump-sum charges for optional software maintenance, which were not fully taxable.

² The Department did not include sales from periods prior to 2005 in the sample because petitioner did not have electronic sales records prior to 2005. Sales after June 30, 2006, were not included because the audit period had originally ended June 30, 2006, but three additional quarters were added to the audit period due to the length of the audit process.

1 nontaxable shipping and handling charge. The Department computed a percentage of error of 1.7486
2 percent for this stratum.

3 The Department examined all 133 invoices for sales greater than \$20,000 for the test period and
4 found six errors, including three claimed nontaxable sales to an insurance company, one claimed
5 nontaxable shipping and handling charge, and two claimed sales for resale. The Department used the
6 percentages of error to compute the disallowed nontaxable sales in the two tested strata, and added
7 those amounts to the errors found in the review of all sales greater than \$20,000, to compute total
8 disallowed nontaxable sales of \$402,990. The Department noted that, for the test period, recorded
9 nontaxable sales totaled \$21,210,912, while the amounts of nontaxable sales claimed on returns totaled
10 \$20,959,756. The Department used the total amount of disallowed recorded nontaxable sales for the
11 test period to compute percentages of error of 1.8999 percent in recorded taxable sales and
12 1.9227 percent in claimed nontaxable sales. The Department noted that, since the sample was chosen
13 from recorded, rather than claimed, nontaxable sales, the 1.8999 percent was more representative than
14 the 1.9227 percent. Therefore, for the period that petitioner provided recorded nontaxable sales, the
15 Department multiplied those figures by 1.8999 percent to compute disallowed nontaxable sales.
16 However, since electronic sales records were not available for periods prior to 2005, the Department
17 computed disallowed claimed nontaxable sales for the period July 1, 2003, through December 31,
18 2004, by applying 1.9227 percent to the claimed amounts. The Department then added the amounts
19 disallowed for the three periods (prior to 2005, 1Q05 through 2Q06, and after 2Q06) to establish the
20 understatement of \$1,794,447 in dispute. We note that other errors found in the examination of the
21 sample invoices, such as handling charges recorded under a specific code and drop shipments, were
22 shown separately in the audit report.

23 Petitioner does not dispute the Department's finding that the specific sales identified in the
24 stratified statistical sample were errors. Instead, petitioner objects to the Department's method of
25 projecting the test results. In short, petitioner contends that the errors should have been established on
26 an actual basis, with no projection to the portion of the population that was not tested because, if the
27 strata had been established correctly, there would have been fewer than three errors in each sub-
28 population, and projection of the errors would have been contrary to Board policy. (See Field Audit

1 Manual section 1308.05.) Petitioner argues that the population should have been divided into
2 homogeneous strata, citing Field Audit Manual section 1304.15, which states that, in a stratified
3 sample, the population ideally should be divided into sub-populations according to similar types of
4 characteristics, such as periods, product lines, customer types, sales locations, dollar ranges, etc.
5 Petitioner asserts, for example, that a separate percentage of error should be computed for disallowed
6 claimed nontaxable sales to insurance companies and projected to sales in that group. Similarly,
7 petitioner states that the errors in its claimed nontaxable sales for resale should not be grouped in a test
8 with erroneously claimed nontaxable handling charges. Moreover, petitioner contends that the
9 disallowed claimed nontaxable handling charges should be removed from the sample because a
10 separate error for disallowed claimed nontaxable handling charges was established in the audit.

11 Petitioner and the Department agree that there were deficiencies in the sample, and we concur.
12 It would have been better to draw a number of samples by category of sales, such as claimed sales for
13 resale, claimed nontaxable labor, etc. However, petitioner had not segregated its recorded sales into
14 those categories. In the absence of readily available information regarding the sales in each of those
15 sub-populations, we find that the Department chose an efficient method of testing the total population
16 of claimed nontaxable sales in a manner that covers a substantial proportion of the dollars of recorded
17 nontaxable sales. Further, we find that the Department defined and limited the population to be tested
18 to the extent possible, based on the available records. For example, the Department excluded recorded
19 exempt sales in interstate and foreign commerce from the sampled population because those sales
20 could be readily identified in the records, and the Department had concluded that recorded amounts
21 were substantially accurate. The Department also removed from the test population all nontaxable
22 handling charges recorded under a specific code and claimed nontaxable charges for drop shipments,
23 based on additional data provided by petitioner after the initial test was conducted. It is our
24 understanding that petitioner provided no records conducive to further defining and limiting of the
25 population. Since it was not possible from the records to identify the populations of sales, by category,
26 we find that the Department's decision to stratify the population using the dollar amounts of the sales
27 was appropriate and that the test provided a representative reflection of the errors in petitioner's
28 recorded nontaxable sales. We find the stratification was valid, and since each such strata whose error

1 was projected had more than three errors, we find that the projection of those errors was the correct
2 audit method. We recommend no adjustments.

3 **OTHER DEVELOPMENTS**

4 None.

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

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3	Transactions Examined	Nontaxable sales
4	Confidence level	80%
5	Confidence interval	49.3610% (stratum 1) 61.4992% (stratum 2)
6	Total number of items in the population	1,289 (stratum 1) 10,409 (stratum 2)
7	Number of items randomly selected for the test	347 (stratum 1) 353 (stratum 2)
8	Number of errors found	8 (stratum 1) 18 (stratum 2)
9	Whether stratification was used, and if so what was stratified	Stratum 1: \$3,000 - \$20,000 Stratum 2: \$ 100 - \$ 3,000 Stratum 3: over \$20,000 (actual basis review)
10	Average dollar value of population	\$6,797.04 (stratum 1) \$ 607.33 (stratum 2)
11	Dollar value of remaining errors	\$42,662 (stratum 1) \$ 4,493 (stratum 2)
12	Dollar value of sample	\$2,439,789 (stratum 1) \$ 213,808 (stratum 2)
13	Percentage of error	1.7486% (stratum 1) 2.1014% (stratum 2)
14	Were XYZ letters sent	Yes
15	Number of XYZ letters sent	12*
16	Percentage of XYZ letters sent in relation to number of questioned items	Unknown*
17	Number of responses to XYZ letters received	12
18	Percentage of responses to XYZ letters received in relation to the number of XYZ letters sent	100%
19	Number of responses to XYZ letters received accepted as proof of valid exempt/nontaxable sales	9
20	Percentage of responses to XYZ letters received accepted as proof of valid exempt/nontaxable sales	75%
21	Number of responses to XYZ letters treated as taxable	3
22	Percentage of responses to XYZ letters treated as taxable	25%
23		

* Although the percentage cannot readily be computed, we note that only a few of the questioned nontaxable sales were claimed sales for resale.