

CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION FINAL ACTION SUMMARY

In the Matter of the Petitions for Redetermination)
 Under the Sales and Use Tax Law of:)
)
 The Auto Store of Merced, Inc.) Account Number: SR KH 097-042792
) Case ID's 478614 & 476975
)
 Sana Sadeddin) Account Number: SR KH 100-484491
) Case ID 476973
)
 Petitioners) Modesto, Stanislaus County

Type of Business: Used car dealer

Audit Period: 10/1/02 – 6/30/06 (Case ID 478614)
 10/1/04 – 6/30/06 (Case ID's 476973 & 476975)

| Item | Disputed Amount | | | |
|-----------------------------------|---------------------|--------------------|-----------------------|-------------------|
| | 478614 | | 476973 & 476975 | |
| | Tax | Penalty | Tax | Penalty |
| Unreported taxable sales | \$4,497,958 | | \$462,923 | |
| Bad debts not claimed | not specified | | not specified | |
| Negligence penalty | \$20,375 | | \$2,949 | |
| | <u>\$203,745.33</u> | <u>\$20,374.52</u> | <u>\$29,488.40</u> | <u>\$2,948.83</u> |
| As determined, protested | | | | |
| Proposed tax redetermination | \$203,745.33 | | \$29,488.40 | |
| Interest through 2/28/11 | 104,271.31 | | 8,790.13 ² | |
| Penalty | <u>20,374.52</u> | | <u>2,948.83</u> | |
| Total tax, interest, and penalty | \$328,391.16 | | \$41,227.36 | |
| Payments | <u>-3,593.35</u> | | <u>-33,714.24</u> | |
| Balance due | <u>\$324,797.81</u> | | <u>\$7,513.12</u> | |
| Monthly interest beginning 3/1/11 | <u>\$1,167.55</u> | | | |

The Board hearing in this matter was held on September 14, 2010. The Board allowed petitioner 30 days to provide additional evidence to support their contentions and the Sales and Use

¹ The primary determination was issued to Sana Sadeddin (476973) and a dual determination was issued to the corporation (476975) for the same liability, less a payment of \$1,152.00 applied to the liability. Thus, the determination issued to the corporation was for tax of \$28,336.40 (compared to the determination of tax of \$29,488.40 issued to Ms. Sadeddin), and was otherwise in the same amounts as issued to Ms. Sadeddin.

² Tax paid in full January 5, 2009.

1 Tax Department (Department) 30 days to respond. At the hearing, petitioners stated that their records
2 were being held by the U.S. Attorney's office and therefore were not available to petitioners to mount
3 a defense. The Board directed the staff to contact the U.S. Attorney's office to determine what records
4 are being held and to request permission for petitioners to have access to those records. The Board
5 also directed the staff to discuss with petitioners if they would agree to have the Department contact
6 financial institutions in order to obtain documentation regarding rollbacks, unwinds, and bad debts, and
7 to make petitioners aware that this action may lead to an increase in their audit liability. Subsequently,
8 the Department sent a request letter dated September 29, 2010, to the U.S. Attorney Benjamin B.
9 Wagner, but no response has been received. The Department also sent a request letter dated October 1,
10 2010, to petitioners asking for their permission to contact financial institutions, but petitioners did not
11 respond. Thus, our conclusion remains that no adjustments are warranted to the determined liabilities,
12 as discussed below.

13 **BACKGROUND**

14 The Sales and Use Tax Department (Department) concurrently audited the records of
15 petitioners because their records were commingled. Ms. Sadeddin, who was the wife of Mr. Abdul
16 Jawad, president of The Auto Store of Merced, Inc. (ASMI), did not obtain a Department of Motor
17 Vehicle (DMV) dealer license for her location. Instead, she sent records of her sales to DMV on
18 reports of sale (ROS) that had been issued to ASMI. Additionally, the Department was uncertain of
19 the true ownership of Ms. Sadeddin's business operations and thus issued a dual determination against
20 ASMI for the same liability apparently incurred by Ms. Sadeddin (less a payment of \$1,152.00 applied
21 to that liability before the determination was issued to ASMI).

22 **UNRESOLVED ISSUES**

23 **Issue 1:** Whether adjustments are warranted to the unreported taxable sales. We recommend
24 no adjustment.

25 During the audit, petitioners informed the Department they had hired a new accountant in the
26 fall of 2005. Petitioners indicated that the prior accountant was unwilling to release financial
27 information or records to them or to the new accountant. The Department asked petitioners to
28 reconstruct their sales records for the entire audit period for each location, and petitioners did so.

1 The Department's analysis of the records and the ROS issued to petitioners disclosed that there
2 was no understatement of taxable sales for the period from the fourth quarter 2002 (4Q02) through
3 3Q03 and that the database provided for the period 4Q03 through 2Q06 was relatively complete. Since
4 the Department concluded that the amounts of sales tax reimbursement petitioners charged on their
5 contracts were substantially accurate, it decided to conduct the audits based on a reconciliation of
6 accrued and reported sales tax. The Department compared recorded amounts of sales tax
7 reimbursement from the reconstructed records with reported sales tax and found that ASMI and
8 Ms. Sadeddin understated their reported tax liability by \$332,277 and \$34,280, measured by
9 \$4,497,958 and \$462,923, respectively.

10 Petitioners contend that the reconstructed sales database contains duplications, and that all sales
11 of vehicles with the same VIN, except the last sale in the series, represent unwinds or rollbacks.
12 Petitioners state that DMV ROS were prepared for each transaction and that sales sometimes were
13 canceled after the DMV ROS were prepared. Petitioners assert that adjustments of approximately
14 \$700,000 are warranted for these uncompleted sales. The Department indicated it was not aware of
15 any duplicate sales in the reconstructed records, and it asked petitioners to identify any sales for which
16 the very same vehicle was resold within a month or two after a prior sale and to provide records
17 showing the vehicle was in fact returned to inventory and resold. Although we allowed 30 days from
18 the conference date to provide the requested information, petitioners have not provided any evidence
19 supporting the claimed duplicate sales. We also have examined the audit workpapers and found no
20 obvious duplications or other inherent errors in the audit methodology or in the audit computations. In
21 the absence of evidence to support petitioners' contentions, we conclude that no adjustment is
22 warranted.

23 **Issue 2:** Whether adjustments are warranted to the audited amount of bad debts. We
24 recommend no adjustment.

25 The Department found that petitioners had maintained loss reserve accounts with finance
26 companies, had recorded bad debts related to dealer-financed transactions, and had claimed bad debts
27 on income tax returns with respect to bad debts for which they had not claimed deductions on sales and
28 use tax returns. Based on its analysis of recorded repossession losses for 62 transactions, the

1 Department computed that the percentage of recorded losses related to taxable sales was 89.72 percent.
2 The Department applied this percentage to the amounts charged against the reserve loss account and to
3 recorded losses related to dealer-financed transactions and established allowable bad debt deductions
4 for ASMI and Ms. Sadeddin of \$1,739,592 and \$64,685, respectively.

5 Petitioners contend that the amounts of bad debts allowed should be increased. Petitioners
6 claim they sold contracts to financial institutions at a 10 to 15 percent discount, and these discounts,
7 which were separate from the reserve amounts, should be included as additional bad debts because
8 they were never received by petitioners. The Department responds that the discount amounts are a cost
9 of doing business for financing transactions that are paid in full and are not deductible. However, the
10 Department opined at the conference that, for defaulted financing transactions, petitioners may be
11 entitled to include the discount amounts in the bad debt computation. Although we allowed petitioners
12 30 days from the conference date to provide us with evidence of discounts related to sales for which
13 the purchasers defaulted on the financing contracts, they have not done so. In any event, the D&R
14 concludes that discounts allowed when petitioners sold contracts to financial institutions, which are
15 separate from the reserve amounts specified in the recourse contracts, are more in the nature of interest
16 on a loan. On that basis, the D&R finds that those discounts are not allowable as a bad debt deduction
17 regardless of whether the purchasers completed their payments or defaulted on their loans.
18 Accordingly, we conclude that no adjustment is warranted to the amount of unclaimed bad debts the
19 Department has already allowed.

20 **Issue 3:** Whether petitioners were negligent. We conclude that they were.

21 The Department asserted penalties for negligence because of the large understatements found in
22 petitioners' audits. The Department noted that, although ASMI hired several accountants and
23 converted to a software accounting system which resulted in accurate reporting of sales for the early
24 part of the audit period (4Q02 through the 3Q03), petitioners did not provide worksheets to support the
25 amounts reported on sales and use tax returns for ASMI and Ms. Sadeddin. Also, since the records for
26 the two petitioners were commingled, it was difficult for them to correctly report sales made under the
27 individual permits. Petitioners dispute the negligence penalties on the basis that they hired and relied
28

1 on CPA firms to maintain their records and prepare financial statements. Also, they assert that the lack
2 of records is the result of the prior accountant's refusal to produce summary records.

3 As previously noted, summary records were not initially available for audit, and there were no
4 sales tax worksheets to support the reported amounts. Petitioners subsequently provided reconstructed
5 sales records from a download of the accounting software, and the understatement is based on a
6 reconciliation of the sales tax accrual account in those reconstructed records and reported sales tax.
7 Although petitioners allege that the audit deficiencies include \$700,000 in duplicate sales, they have
8 not provided supporting documentation. Further, even if that adjustment were supported, it would not
9 fully explain the audited understatements of taxable sales of \$4,497,958 for ASMI and \$462,923 for
10 Ms. Sadeddin. Accordingly, the available records support a finding that petitioners' reported taxable
11 sales were substantially less than recorded amounts. Additionally, petitioners recorded substantial
12 amounts of bad debt losses, but they neglected to claim deductions for the amounts to which they were
13 entitled. We find that the significant differences between recorded and reported taxable sales and the
14 failure to claim bad debt deductions are evidence that petitioners did not exercise due care in reporting.

15 With respect to their argument that they were not negligent because they relied on accountants,
16 we note that taxpayers are ultimately responsible for recording, reporting and paying their proper tax
17 liability. That petitioners hired and relied on CPA firms to maintain their records and prepare financial
18 statements does not absolve them of that responsibility. Petitioners were responsible for ensuring that
19 their CPA's received the correct sales amounts to report on the tax returns, and the evidence suggests
20 that they did not do so. Furthermore, the errors identified in this audit are the same types of errors
21 found in a prior audit of ASMI. Although the percentage of error was approximately 47 percent in the
22 prior audit and 11 percent in the current audit, which is an improvement, the dollar amount is still
23 substantial and the repeated audit error is additional evidence of negligence. For all these reasons, we
24 conclude that petitioners were negligent and the negligence penalty was properly imposed.

25 **OTHER DEVELOPMENTS**

26 None.

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28 Summary prepared by Rey Obligacion, Retired Annuitant