CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION FINAL ACTION SUMMARY

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of:	
BENALEX WINDOWS & DOORS CORP.	Account Number SR AA 97-750114 Case ID 446664
Petitioner	Los Angeles, Los Angeles County

Type of Business: Sales of windows

Audit period: 07/01/04 – 06/30/07

Item	Disputed Amount[1]
Disallowed claimed and netted nontaxable sales	$1,413,113
Unreported taxable sales	$2,616,705
Negligence penalty	$ 33,692

	Tax	Penalty
As determined	$667,763.73	$66,776.41
Pre-D&R adjustment	+ 12,309.35	+ 1,230.95
Post-D&R adjustment	- 55,757.42	- 5,575.75
Post-Board hearing adjustment	- 287,392.29	- 28,739.21
Proposed redetermination	$336,923.37	$33,692.40
Less concurred	- 4,463.33	00.00
Balance, protested	$332,460.04	$33,692.40

Proposed tax redetermination	$336,923.37
Interest through 02/28/14	176,797.49
Negligence penalty	33,692.40
Total tax, interest, and penalty	$547,413.26
Payments	-132,128.24
Balance Due	$415,285.02
Monthly interest beginning 03/01/14	$ 1,023.98

The Board held a hearing regarding this matter on February 27, 2013, granting petitioner 30 days to conduct another test of nontaxable sales and the Sales and Use Tax Department (Department) 30 days to respond. The matter was scheduled on the non-appearance calendar for January 2014 in Sacramento, but was postponed at petitioner's request in order for it to have an opportunity to address the Board on the day it considers this matter in Culver City. Based on

[1] Petitioner has not specified what portion of the audit items it disputes, so the entire amounts are treated as disputed.

petitioner's submissions and the Department's response, we recommend a reduction in the amount of disallowed claimed and netted nontaxable sales of $3,483,543, from $4,896,656 to $1,413,113, as discussed below under Post Hearing Developments.

UNRESOLVED ISSUES

Issue 1: Whether adjustments are warranted to the disallowed claimed and netted nontaxable sales. We find no further adjustment is warranted other than the adjustment addressed under "Post Hearing Developments."

Petitioner manufactures and sells window frames, glass, and screens. Petitioner did not provide a general ledger or other summary records that had been completed contemporaneously with the sales. However, it did provide source documents that the Department found to be reasonably complete. In its review of nontaxable sales, the Department used the third quarter 2004 (3Q04) as a test period. The Department found that petitioner's invoices for nontaxable sales (which included both sales for resale and charges for labor) totaled $536,675, which exceeded the claimed deduction for nontaxable sales of $360,529 by $176,146. Accordingly, the Department used $536,675 as the amount of claimed and netted nontaxable sales for the 3Q04, and it computed a percentage of error in the claimed deduction of 48.86 percent ($176,146/$360,529). To establish the audited amount of claimed and netted nontaxable sales for the remainder of the audit period, the Department applied 48.86 percent to the claimed deduction for each quarter. (The ratio was not used to determine the measure of tax, but as an audit shortcut to determine the total amount of claimed and unreported nontaxable sales.) The Department then reviewed each of the invoices for nontaxable sales for 3Q04 and found that 71.62 percent of those sales were not adequately documented, and it applied that percentage to the audited amount of claimed and netted nontaxable sales to establish the disallowed amount for the audit period.

After the appeals conference, the Department concluded that it was inappropriate to apply the 48.86 percent to claimed deductions for nontaxable sales for the entire audit period. Instead, the Department noted that it had compared recorded and reported taxable sales on a quarterly basis for the period January 1, 1995, through March 31, 2007, and it observed that the percentage fluctuated from quarter to quarter. The Department reasoned that the percentage of understatement in claimed nontaxable sales would fluctuate in a similar manner. Based on our review of the audit workpapers, we concur, and we recommended that adjustment in the D&R. Accordingly, to establish the claimed and netted nontaxable sales in the reaudit, instead of applying 48.86 percent to claimed nontaxable sales for the entire audit period, the Department applied the percentage of understatement in reported taxable sales to the claimed deduction for nontaxable sales, on a quarter-by-quarter basis for periods beginning January 1, 2005. It then applied 71.62 percent to the claimed and netted nontaxable sales for each quarter to compute the disallowed amount.

Petitioner concedes that the amount of claimed and netted nontaxable sales is overstated, but argues that the difference established in the audit should be adjusted by an unspecified amount. Petitioner asserts that its reporting practices improved in the later portions of the audit period but has provided no documentation to show that its reporting became more accurate in the later quarters of the audit period. Also, petitioner has provided no evidence that the percentages of error in its claimed nontaxable sales were less than the percentages of error in its reported taxable sales. Accordingly, in the absence of supporting documentation, we find no further adjustment is warranted.

Issue 2: Whether adjustments are warranted to the unreported taxable sales. We find no adjustment is warranted.

After the Department notified petitioner of the impending audit, petitioner retained an accountant to produce a rudimentary single-entry sales journal. Using that journal, the Department reconciled the amount of sales tax accrued and sales tax reported for the period January 1, 2005, through March 31, 2007. Using the difference between the accrued and reported sales tax, the Department computed a difference between recorded and reported taxable sales of $2,246,858. It then used that difference to compute a percentage of error of 347.88 percent, which it applied to reported taxable sales to establish the unreported amount for 3Q04 and 4Q04. Based on its review of the records, the Department concluded that reported taxable sales for 2Q07 were substantially accurate. Petitioner concedes that it had recorded taxable sales that were not reported, but argues that the audited difference is overstated by an unspecified amount.

The amount of unreported taxable sales is based primarily on petitioner's recorded taxable sales. Petitioner has provided no evidence that its recorded taxable sales were overstated. Further, the Department reconciled recorded and reported taxable sales for nine quarters, and we find it was appropriate for the Department to apply the percentage of error computed for those nine quarters to reported amounts for two earlier quarters for which no summary records were provided. Thus, we find no adjustment is warranted.

Issue 3: Whether petitioner was negligent. We find that it was.

The Department imposed a negligence penalty because petitioner did not provide adequate books and records, and the understatement was substantial. Petitioner disputes the penalty on the grounds that its president is an immigrant who was not aware of the recordkeeping requirements, and that some of the errors occurred because its bookkeeper suffered from a deep depression.

For the period January 1, 2005, through March 31, 2007, the only period for which petitioner provided summary records, recorded taxable sales exceeded reported amounts by $2,616,705, which represented an understatement of almost 350 percent. In addition, petitioner did not retain sufficient documentation to support 40 percent of its claimed and netted nontaxable sales. We find that any business person, even one with limited experience, should have recognized discrepancies of this magnitude, particularly the difference between recorded and reported taxable sales. With respect to petitioner's argument regarding its president's alleged inexperience, we note that petitioner was sufficiently aware to correctly compute and collect sales tax reimbursement and should have recognized that it was necessary to report the tax. Regarding petitioner's assertion that the bookkeeper's errors were the result of illness, we find that petitioner is responsible for the accuracy of reported amounts compiled by its employees or agents. We find that petitioner's failure to report tax on *recorded* taxable sales exceeding $2.5 million and its failure to provide documentation to support a substantial percentage of its claimed and netted nontaxable sales are evidence of negligence, even though petitioner had not been audited previously. Thus, we find that the negligence penalty was properly applied.

POST HEARING DEVELOPMENTS

At the Board hearing, petitioner contended that the error percentage of 71.62 percent derived from the test of 3Q04 is not representative of its business for subsequent periods because its record keeping improved after the 4Q04. After the hearing, petitioner conducted a test of nontaxable sales for 3Q06. To support the nontaxable sales, petitioner provided seller's permit numbers and business information for several customers. Using that information and the Board's computerized records, the Department identified sales made to purchasers who held seller's permits and were engaged in the business of reselling the type of property sold by petitioner, and it regarded those sales as nontaxable. For 3Q06, the Department computed an error rate of 36.23 percent.

In addition, the Department concluded that the some of the sales that had been disallowed in the test of 3Q904 were valid sales for resale, based on sales invoices, with seller's permit numbers, that petitioner provided for 1Q05. Further, the Department revised the audit methodology to fully account for sales regarded as taxable by petitioner, such that the percentage of error was not applied to sales already included in the unreported taxable sales of $2,616,705. As a result of that change in audit methodology and the Department's conclusion that some of the previously disallowed sales for resale should be accepted as valid, the Department reduced the percentage of error computed for 3Q04 from 71.62 percent to 43.96 percent.

The Department computed an average percentage of error of 40.10 percent [(36.23% + 43.96%) ÷ 2]. It applied that percentage of error to claimed and netted nontaxable sales to compute the disallowed amount of $1,413,113. We concur with the Department's findings, and we recommend a reduction of the disallowed claimed and netted nontaxable sales of $3,483,543, from $4,896,656 to $1,413,113.   Petitioner has not provided evidence to support an adjustment to the unreported taxable sales, and we recommend no further adjustments.

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