

1 CALIFORNIA STATE BOARD OF EQUALIZATION

2 APPEALS DIVISION FINAL ACTION SUMMARY

3 In the Matter of the Petition for Redetermination)
 4 Under the Sales and Use Tax Law of:)
 5 MAS N ZUL, INC., dba Ride-way Auto Service) Account Number: SR AR 97-733371
 Case ID 434597)
 6 Petitioner) Santa Clarita, Los Angeles County

7 Type of Business: Automobile repair shop

8 Audit period: 04/01/04 – 03/31/07

9 Item Disputed Amount

10 Unreported taxable sales \$315,693¹

11 Tax as determined and proposed to be redetermined: \$27,064.44

12 Less concurred 1,019.70

12 Balance, protested \$26,044.74

13 Proposed tax redetermination \$27,064.44

14 Interest through 11/30/10 10,576.63

Total tax and interest \$37,641.07

15 Payments -7,000.00

15 Balance Due \$30,641.07

16 Monthly interest beginning 12/1/10 \$117.04

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 18 The Board heard this matter on June 18, 2010, granting petitioner 30 days to provide additional
 19 records to support certain contentions and the Sales and Use Tax Department (Department) 30 days to
 20 respond. We find no adjustment is warranted as discussed below under Post Hearing Developments.

21 **UNRESOLVED ISSUE**

22 **Issue:** Whether adjustments are warranted to the audited amount of unreported sales. We
 23 recommend no adjustment.

24 Petitioner operates an auto repair shop. In addition to making repairs, petitioner made over-the-
 25 counter sales of auto parts, both at retail and for resale. The Department reduced recorded
 26 merchandise purchases by the recorded amounts of subcontractor labor included therein to compute an

27 _____
 28 ¹ Petitioner protests an unspecified portion of the audited understatement of reported sales.

1 audited cost of parts sold of \$416,595 for the period January 1, 2004, through March 31, 2007. That
2 figure significantly exceeded the total of reported taxable sales of parts and claimed sales for resale of
3 \$180,433 (\$122,355 + \$58,078) for the audit period. The Department decided to establish audited
4 taxable sales on a markup basis.

5 The Department computed an audited markup of 28.44 percent, using selling prices from sales
6 invoices and costs from purchase invoices for the months of January, November, and December 2005.
7 The Department added that markup to the audited cost of parts sold to compute audited parts sales for
8 the period of \$496,126 for the audit period.² It deducted reported total sales of parts (both taxable and
9 nontaxable) of \$180,433 to compute an understatement of reported taxable sales of parts of \$315,693,
10 which represents a percentage of error of 258 percent ($\$315,693 \div \$122,355$).³

11 Petitioner did not protest the audited markup prior to the Board hearing, but contended that the
12 audited cost of parts sold should be reduced to account for defective parts returned to vendors,
13 defective parts thrown away, purchases of supplies and tools included in the recorded purchases of
14 merchandise, and excessive spillage of motor oil and lubricants.

15 We would expect petitioner's vendors to issue credits to petitioner for defective parts it
16 returned, and petitioner acknowledged at the conference that this is the case. Further, we would expect
17 such credits to be reflected on purchase invoices or credit memos issued to petitioner, and we would
18 expect petitioner to record the net amount of purchases in its records. Petitioner asserts, however, that
19 some of those credits were not accounted for in its recorded merchandise purchases and that defective
20 small parts were not always returned to vendors for credit, but were sometimes discarded.

21 Petitioner has not provided documentation, such as purchase invoices and the details of
22 recorded amounts of merchandise purchases, to show that the credits from vendors have not been
23 accounted for in petitioner's records. In addition, petitioner has provided no documentation of
24 defective small parts that were discarded rather than returned to the vendors. Furthermore, since

26 ² The Department computed audited sales of \$535,074 ($\$416,595 \times 1.2844$) for the period January 1, 2004, through
27 March 31, 2007) and deducted an estimated amount of sales for the first quarter 2004 of \$38,948 (25 percent of \$155,791,
the sales computed for the year 2004).

28 ³ That is, the Department accepted petitioner's claimed resales of \$58,078 as valid. The audit workpapers do not include a
comment addressing whether the Department actually verified the claimed resales. We note also that, despite the
significant percentage of error, the Department did not impose a penalty for negligence.

1 petitioner routinely returned defective parts to vendors for credit (as it concedes), we find it
2 implausible that petitioner would have thrown away a material amount of small defective parts rather
3 than returning them along with its other returned merchandise. In the absence of documentation, we
4 recommend no adjustment for alleged unrecorded credits from vendors or alleged discarding of small
5 defective parts. Similarly, petitioner has not provided documentation that purchases of supplies and
6 tools were inadvertently included in its recorded merchandise purchases. In the absence of
7 documentation, we recommend no adjustment.

8 Nor has petitioner provided documentation that it had significant spillage of oil and lubricants.
9 Petitioner opened this business in August 2000, more than three years before the beginning of the audit
10 period. Thus, petitioner was experienced in this business by the time the audit period began.
11 Accordingly, we would expect it to have implemented procedures to prevent excessive spillage of oil
12 and lubricants. We find that petitioner has not established that it had significant spillage of oil and
13 lubricants, and we recommend no adjustment for this claim.

14 Petitioner did not raise the issues of self-consumption and pilferage, and they are not directly
15 addressed in the D&R. The types of merchandise withdrawn from inventory for self-consumption for
16 which an adjustment might be warranted would be parts used by the owners for repairing their own
17 cars. We would expect this type of self-consumption to be nominal, and even had there been some,
18 petitioner would still owe tax on the cost of the parts, meaning that any adjustment for self-
19 consumption would be minimal. With respect to pilferage, petitioner ordered parts for each job on an
20 as-needed basis and did not keep an inventory of parts other than nuts, bolts, washers, and other similar
21 items so any losses due to pilferage of those small items would have been minimal. Accordingly, since
22 petitioner did not raise these issues and we would expect the amounts, if any, to be minimal, we do not
23 recommend any adjustments for self-consumption or pilferage.

24 **POST HEARING DEVELOPMENTS**

25 The issues addressed at the hearing for which the Board sought responses were: 1) whether the
26 audited markup should be reduced to reflect sales of tires at a 5 percent markup, 2) whether the audited
27 cost of goods sold should be adjusted for unrecorded credits for returned merchandise, and 3) whether
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1 the adjustment for increased inventory of tires should be deleted. The Department also reconsidered
2 whether a negligence penalty should have been applied.

3 When the Department contacted petitioner after the hearing, petitioner stated it no longer
4 wishes to pursue the contention that the audited markup should be reduced to reflect sales of tires at a
5 5 percent markup. With respect to the contention that the audited cost of goods sold should be reduced
6 for unrecorded credits from vendors, petitioner had sent numerous credit memos from vendors to the
7 Board Proceedings Division after the Board hearing. Board Proceedings sent those credit memos to
8 the Department, and the Department copied them, scheduled them, and returned the originals to
9 petitioner. When contacted by the Department regarding additional explanation and documentation,
10 petitioner stated that all documentation had already been provided and it had nothing further. The
11 Department concluded that the credit memos, standing alone, were not sufficient to support an
12 adjustment to audited cost of goods sold because there was no way to determine how, or if, the credit
13 memos had been recorded in petitioner's records. We concur with the Department on this issue.

14 Without complete books and records, there is no way to verify petitioner's claim that it did not reduce
15 its recorded purchases for the amounts of the vendors' credits for returned merchandise. Therefore, we
16 find the credit memos alone are not sufficient to support adjustments to the audited cost of goods sold.

17 In reexamining the issues of the adjustment for increased inventory and whether the negligence
18 penalty should have been applied, the Department concluded that both of its prior decisions were
19 correct, to allow the inventory adjustment and to forego a negligence penalty. We note also that, even
20 if it were determined that no adjustment should have been made for increased inventory or that a
21 negligence penalty should have been imposed, no adjustment to increase the liability could be made
22 now because none was not asserted at or before the Board hearing. (Rev. & Tax. Code § 6563 (had
23 there been some adjustment reducing the asserted liability after issuance of the determination, an
24 increase could be made, if appropriate, up to the amount of the determination; there were no such
25 adjustments here).)

26 We conclude that no adjustments are warranted.

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

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MARKUP TABLE

Percentage of purchases whose resale was taxable (if at retail)	100%
Mark-up percentages developed	28.44%
Self-consumption allowed in dollars	None
Pilferage allowed in dollars	None