STATE BOARD OF EQUALIZATION
SALES AND USE TAX APPEAL

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:	)	
PACIFIC WINDOW CORPORATION	)	Account Number: SR EHC 97-005336 Case ID 391906
Petitioner	)	Banning, Riverside County

Type of Business: Manufacture and installation of windows

Audit period: 10/01/01 – 09/30/04

Item	Disputed Amount
Unreported taxable measure, based on material accountability test	$3,052,145
Disallowed claimed bad debt deductions	$472,073
Negligence penalty	$27,681
Relief of interest (accrued since 1/1/06)	$124,097
Amnesty double negligence penalty	$7,977
Amnesty interest penalty	$7,790

	Tax	Penalty
As determined	$438,635.74	$58,221.15
Adjustment: Sales and Use Tax Department	-161,834.95	-22,563.83
Proposed redetermination	$276,800.79	$35,657.32
Less concurred	-2,952.47	00.00
Balance, protested	$273,848.32	$35,657.32

Proposed tax redetermination	$276,800.79
Interest through 10/31/10	175,674.46
Negligence penalty	27,680.17
Amnesty double negligence penalty	7,977.15
Amnesty interest penalty	7,789.86
Total tax, interest, and penalty	$495,922.43
Payments	-4.00
Balance Due	$495,918.43
Monthly interest beginning 11/1/10	$1,614.65

This matter was scheduled for Board hearing on June 17, 2010, but was postponed to allow petitioner's new representative additional time to prepare for the Board hearing. The matter was then scheduled for hearing on October 21, 2010, but petitioner thereafter waived the oral hearing.

UNRESOLVED ISSUES

Issue 1: Whether adjustments are warranted to the audited understatement of taxable measure. We recommend no adjustment.

Petitioner manufactured and installed windows and doors from January 1, 1997, through December 31, 2006. It did not pay tax or tax reimbursement on its purchases of inventory. Petitioner had several types of contracts with respect to which tax was applicable: full install contracts where petitioner furnished and installed materials for a lump sum price; partial install contracts where petitioner furnished and installed some materials for a lump-sum price and also sold the customer other property at retail, collecting tax reimbursement on the sale price of that other property; and sales which were entirely over-the counter retail sales. Change orders to these contracts could have involved lump-sum contracts to furnish and install materials or retail sales of materials or both. Petitioner also made nontaxable sales for resale and exempt sales in interstate commerce.

To report its taxable measure, petitioner used Avante, an accounting software program, which was designed to calculate tax on cost or on the retail selling price, depending on what portion of the materials were installed. At the end of predetermined periods, Avante generated a report showing a compilation of information regarding all of petitioner's sales, as well as separate reports for each type of contract. To calculate the amount of tax due, Avante was dependent on the standard costs for materials and material usage, as well as certain markup codes, which were entered by petitioner's employees. Thus, if those elements of the costs and selling prices were entered incorrectly, Avante calculated an incorrect amount of tax due.

The Sales and Use Tax Department (Department) found that reported total sales substantially reconciled with the amounts recorded in petitioner's general ledger and federal income tax returns. To analyze petitioner's reported taxable measure, the Department performed a material accountability test. It scheduled the total cost of materials recorded on the federal returns and used the Avante reports to calculate a ratio of the cost of materials consumed versus the cost of materials sold for the fiscal years ending (FYE) September 2002, 2003, and 2004. The Department reduced the cost of materials sold at retail by five percent for breakage, then added the cost of materials consumed in lump-sum contracts to establish the total cost of materials accounted for in the Avante reports. The Department compared

those figures with the costs of materials recorded on the federal returns and found materials that were not accounted for in the Avante reports. The Department pro-rated the cost of the materials not accounted for in the Avante reports between the cost of materials sold and the cost of materials consumed, applying the ratios noted above. The Department added the audited cost of materials consumed and reported taxable sales to establish audited taxable measure, which it compared to reported amounts to compute percentages of error of 1.24 percent, 8.57 percent, and 3.68 percent for FYE September 2002, 2003, and 2004, respectively. The Department applied those percentages of error to reported amounts per quarter to compute the understatement of $3,052,145 at issue here.

Petitioner disputes the audited understatement of reported taxable measure, but has not raised any specific contentions. Although it stated at the conference that it would provide documentation to support adjustments, petitioner has not done so. We have reviewed the audit workpapers and have found no inherent errors in the Department's computations. We find the Department took into account all information provided by petitioner, performed the material accountability test correctly, and included the allowance for breakage in accordance with Audit Manual section 1205.20. In contrast, petitioner has not provided additional information or documentation, or even a clear explanation of its disagreement with the audit findings. We find there is no basis for adjustment.

Issue 2: Whether adjustments are warranted to the disallowed amount of claimed bad debt deductions. We recommend no adjustment.

During the audit period, petitioner claimed bad debt deductions totaling $539,891. The Department reviewed petitioner's actual invoices to determine the nature of the transactions for which petitioner had claimed bad debts. The Department determined that bad debt deductions totaling a measure of $67,818 were related to transactions for which petitioner was the retailer of materials. The Department disallowed the remainder of the claimed bad debts, measuring $472,073, which were related to transactions for which petitioner was the consumer of the materials. Petitioner disputes the disallowed claimed bad debt deductions, but has not provided a specific reason.

A retailer is relieved from liability for sales tax insofar as the measure of tax is represented by accounts that have been found to be worthless, provided the sales tax has been paid to the state. A construction contractor may claim bad debt deductions with respect only to transactions for which it

was the retailer of the tangible personal property and may not claim a bad debt deduction with respect to transactions for which it was the consumer of the materials. (Cal. Code Regs., tit. 18, § 1642, subd. (h)(2).) In this case, the Department has reviewed the actual invoices related to the claimed bad debts, and has allowed the claimed amounts that relate to transactions for which petitioner was the retailer and disallowed those that relate to transactions for which petitioner was the consumer of the materials. Petitioner has provided no evidence that any of the disallowed claimed bad debts relate to transactions for which it was the retailer, and we have reviewed the audit workpapers and have found no errors. Accordingly, we find there is no basis for adjustment.

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

The Department imposed the 10-percent penalty for negligence because the amount of understatement of $3,052,145 was significant. Petitioner protests the negligence penalty on the basis that it attempted to correct the reporting errors from the prior audit by using the Avante software. The Department does not dispute petitioner's claim that it purchased the Avante software with the goal of correcting errors found in the first audit. However, according to the Department, petitioner became aware that the Avante program was faulty in July 2002, when an outside accounting firm reviewed the software's calculation of tax and noted that the calculated amounts of tax were directly dependent on amounts entered by petitioner's clerks. The accounting firm explained to petitioner that, if incorrect information was entered, the Avante software would not calculate the correct amount of tax due.

Generally, when the same types of errors are continued from one audit period to the next, the taxpayer's failure to correct the errors identified in the earlier audit period is considered evidence of negligence. In this case, although petitioner appears to have made some effort to correct the reporting errors found in the prior audit, it should have been aware, and definitely became aware no later than July 2002, that the Avante software had the potential of incorrectly calculating the amount of tax due. Despite being aware of the software's limitations, petitioner relied exclusively on the Avante software, and there is no evidence petitioner took any measures to address the concerns identified by the outside accounting firm. Further, although the percentage of unreported taxable measure to reported taxable measure of 4.84 percent ($3,052,145 ÷ $63,017,248) is not large, the amount of understatement, which exceeds $3 million, is substantial. We find the significant amount of understatement, the fact that the

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errors continued from the audit period prior to this one, and petitioner's failure to verify the accuracy of amounts of tax computed by the Avante software, even after it had been notified of the potential for errors, are all evidence that petitioner did not exercise due care in reporting. Therefore, we conclude that the understatement was the result of negligence, and the penalty was properly applied.

Issue 4: Whether relief is warranted from the interest that has accrued since December 31, 2005. We conclude that relief is not warranted.

Petitioner requests relief of interest, asserting that there were unreasonable errors or delays by Board employees and that no aspect of the delays was attributable to petitioner's actions. Petitioner asserts it was prompt in responding to the Department's requests for information. Further, petitioner states that the liability will be approximately the amount listed on the audit report dated November 8, 2005, and it therefore requests relief of the interest that has accrued since December 31, 2005.

Petitioner disputed the audit findings on several occasions and provided additional information and contentions each time. Further, petitioner and the Department agree that the audit was complex because of the various reporting alternatives associated with the company's different types of contracts. The audit field work began in September 2004, an audit report and revised audit report were issued in November 2005 and December 2006, respectively, and the Department issued the Notice of Determination in January 2007. In September 2007, the Department completed a reaudit, based on additional information provided by petitioner. We find this timeline is reasonable given the complexity of petitioner's business and the high volume of sales. We also note that the Department gave petitioner repeated opportunities to provide additional information, and we find the associated delays in the audit were attributable to petitioner. Accordingly, we conclude there is no evidence that Board employees caused unreasonable errors or delays that resulted in petitioner's failure to timely pay the tax.

AMNESTY

Since petitioner did not apply for amnesty and the determination was issued after the end of the amnesty period, the determination includes an amnesty double negligence penalty. Also, when the liability becomes final, an amnesty interest penalty will be applied. After the reaudit, the amounts of those penalties are $7,977.15 and $7,789.86, respectively.

Petitioner has requested relief of the amnesty penalties under Revenue and Taxation Code section 6592, on the grounds that it was unaware of any additional tax due for the amnesty-eligible period, stating that all of its returns had been filed timely and prepared to the best of its knowledge. The Department replies that it sent a letter to petitioner on March 25, 2005, before the end of the amnesty period, explaining the provisions of the amnesty program. Further, the Department states that it discussed its preliminary audit findings with petitioner in March 2005, and those findings reflected an understatement of reported measure of $5 million.

Thus, although petitioner did not agree with the Department's findings, it was made aware of a potential audit liability for the amnesty-eligible period before the deadline for applying for amnesty. Given that its outside accountant had warned petitioner about its reporting problems and the preliminary audit findings, we believe that petitioner knew it was likely to have an outstanding liability for amnesty-eligible period. Further, even if petitioner had a good faith belief that it would eventually prevail through the appeals process, the amnesty program was intended to encourage the payment of disputed liabilities during the appeals process. Instead, petitioner chose not to participate in the amnesty program, or pay the amnesty-eligible tax and interest due by March 31, 2005. We conclude that petitioner's failure to report or pay its amnesty-eligible liability and its failure to participate in the amnesty program was not based upon reasonable cause or circumstances beyond its control, and that there is no basis to recommend relief of the amnesty penalties.

OTHER DEVELOPMENTS

None.

Summary prepared by Rey Obligacion, Retired Annuitant