

CALIFORNIA STATE BOARD OF EQUALIZATION
APPEALS DIVISION SUMMARY FOR BOARD HEARING

In the Matter of the Petition for Redetermination)
Under the Sales and Use Tax Law of:)
TEAM TOYSPORT AMERICA LIMITED) Account Number: SR AS 12-681593
Case ID 333473
Petitioner) Lawndale, Los Angeles County

Type of Business: Sales and repair of automotive parts

Audit Period: 1/1/00 – 12/31/03

| <u>Items</u> | <u>Amounts in Dispute</u> | |
|------------------------------------|---------------------------|-------------------|
| Unreported taxable sales | \$487,864 | |
| Negligence penalty | \$ 3,987 | |
| Amnesty double negligence penalty | \$ 3,987 | |
| Amnesty interest penalty | \$ 6,083 | |
| | <u>Tax</u> | <u>Penalty</u> |
| As determined and protested | <u>\$39,869.74</u> | <u>\$7,974.00</u> |
| Proposed tax redetermination | \$39,869.74 | |
| Interest through 4/30/09 | 27,910.26 | |
| Negligence penalty | 3,987.00 | |
| Amnesty double negligence penalty | 3,987.00 | |
| Amnesty interest penalty | <u>6,082.55</u> | |
| Total tax, interest, and penalties | <u>\$81,836.55</u> | |
| Monthly interest beginning 5/1/09 | <u>\$265.80</u> | |

This matter was previously scheduled for Board hearing on February 6, 2009, but was postponed at petitioner's request because it needed time to continue to gather documentation.

UNRESOLVED ISSUES

Issue 1: Whether any adjustments are warranted to the audited measure of tax due. We recommend no adjustment.

Petitioner, a corporation, sells and repairs foreign automotive parts. Mr. Joel Luz is the sole shareholder for the corporation. Sales were made from showrooms, and by telephone, mail, and Internet. This was petitioner's third audit. Petitioner did not provide adequate books and records for

1 audit, and further, its sales invoices were not pre-numbered, so the Sales and Use Tax Department
2 (Department) could not ascertain if they were complete. The Department also did not know how
3 petitioner reported on its sales and use tax returns. Therefore, the Department decided to establish
4 petitioner's sales by performing a bank deposit analysis. For the years 2000 through 2002, the
5 Department compared the total bank deposits to reported sales and found that the bank deposits
6 exceeded the reported sales by \$1,738,188. The Department adjusted this amount for non-sale and
7 nontaxable deposits such as, returned deposits, loans issued by wire transfer, merchant charge backs,
8 nontaxable freight charges, and sales tax reimbursement included in the bank deposits. Adjusting for
9 these deposits reduced the difference to \$975,727, which the Department regarded as unreported sales.
10 The Department regarded 50 percent of these receipts as from nontaxable or exempt sales, resulting in
11 unreported taxable sales of \$487,864. For the year 2003, the Department accepted the reported sales
12 because the bank deposits reconciled with the reported total sales.

13 Petitioner contended that the audited unreported taxable sales were overstated because
14 insufficient allowances were provided for bank deposits that were for loans, and for nontaxable freight
15 charges. After review of petitioner's post-conference submission, the Department indicated that
16 petitioner provided records to establish further adjustments of \$44,841 in nontaxable freight charges,
17 and \$21,504 in loans from family members and friends. However, the Department does not believe
18 that this evidence justifies a reduction in the deficiency.¹ The Department notes that for the fourth
19 quarter 2002, recorded bank deposits were only \$122,552, while reported total sales were \$279,223,
20 over \$150,000 more than recorded deposits. Since the method used in the audit was to compare the
21 aggregate of bank deposits to the aggregate of reported total sales, the over \$150,000 difference for the
22 fourth quarter 2002 was effectively used to offset deficiencies in the other quarters, reducing
23 petitioner's audited unreported sales. The Department states that this audit method was not logical
24 because the difference between reported sales and deposit for the fourth quarter 2002 should not have
25 been used to offset the deficiencies for other quarters. Therefore, the Department proposes accepting

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27 ¹ If the Department were to apply these adjustments to its previous method of calculating the deficiency, it would have
28 reduced the measure of deficiency by \$33,172 (\$44,841 plus \$21,504 for a total reduction in unreported sales of \$66,345,
multiplied by 50 percent to calculate a reduction of \$33,172 to unreported taxable sales)

1 petitioner's total sales as reported in the fourth quarter 2002, and analyzing the remaining audit period
2 on a quarter-by-quarter basis. Using this method, and adjusting for the increased loans and nontaxable
3 freight charges supported by the post-conference submission but not allowing the offset for the fourth
4 quarter 2002, the Department contends that the unreported taxable sales should be \$527,603, rather
5 than \$487,864. The Department has not, however, asserted an increase above the determined liability,
6 pursuant to Revenue and Taxation Code section 6563.

7 Petitioner contends that the Department should not change methodology, and also contends that
8 additional allowances should be made for loans of: \$5,000 from its attorney Arthur V. Medel; \$14,700
9 from Andy J. Changchi; and \$20,000 from Josie Luz or Teresa Luz. Petitioner further contends that
10 the entire audit liability should be cancelled because the excess bank deposits were actually the result
11 of short term loans from friends and family it received to cover cash shortfalls by the business.
12 Alternatively, petitioner believes that only 25 percent of the difference between bank deposits and
13 reported total sales (rather than 50 percent) should be regarded as unreported taxable sales.

14 We find that the correct bank deposit analysis methodology is to compare bank deposits and
15 total sales for each reporting period. Petitioner has not provided an explanation for why reported total
16 sales exceeded bank deposits in the fourth quarter 2002. Petitioner recorded \$122,552 in bank deposits
17 for the fourth quarter 2002. In the eleven preceding quarters, petitioner always recorded at least
18 \$263,353 in bank deposits. On average, petitioner recorded \$375,537 in bank deposits for the
19 preceding eleven quarters. The reported total sales were not correspondingly low in the fourth quarter
20 2002. In fact, the reported total sales for the fourth quarter 2002 was higher than any of the eleven
21 preceding quarters. For the eleven preceding quarters, petitioner always reported total sales of between
22 \$180,652 and \$236,980. The unexplained and sudden drop in bank deposits in the fourth quarter 2002
23 suggests that petitioner may have begun to deposit gross receipts in another bank account. Under these
24 circumstances, we conclude that the unexplained and sudden drop in bank deposits for the fourth
25 quarter 2002 should not serve as a credit to reduce unreported taxable sales in other quarters.

26 After the Department's allowances for deposits from non-sale and nontaxable transactions, *and*
27 the offset for the fourth quarter 2002 discussed above, petitioner had \$975,727 in bank deposits that
28 had not been reported but could not otherwise be accounted for as anything other than gross receipts

1 from the sale of tangible personal property. Petitioner argues that the taxable sales ratio of its *reported*
2 sales, which was accepted by the Department, should be applied to these *unreported* sales. The
3 Department does not agree that the unreported sales are necessarily taxable in the same ratio as
4 reported sales. Under the circumstances here, where the Department does not even know the method
5 used by petitioner to report tax and cannot determine the source of the unreported sales, we believe the
6 Department acted generously in assuming that 50 percent of the unreported sales were exempt or
7 nontaxable sales. We do not recommend any additional adjustments for exempt or nontaxable sales.

8 We do not see how the payment from petitioner's attorney, Mr. Medel, was a loan. Petitioner
9 also does not indicate when the alleged loan was repaid. The Department did not accept the payment
10 from Josie Luz or Teresa Luz as a loan because the bank statement indicates the origin of the statement
11 is unknown. We believe the Department acted appropriately in not accepting the payment of unknown
12 origins as a loan. While we believe that the payment of \$14,700 from Mr. Changchi should be
13 regarded as a loan, adding this to the adjustments conceded by the Department (\$44,841 for nontaxable
14 freight charges, \$21,504 for loans from family members and friends) totals \$81,045, would be more
15 than offset by the increase of \$156,671 in taxable sales that results from performing the bank deposit
16 analysis correctly, on a quarter-by-quarter basis, and accepting the reported sales for the fourth quarter
17 2002. Thus, we believe that the actual deficiency remains more than the amount determined by the
18 Department, and therefore recommend no change to the determined measure of tax due.

19 **Issue 2:** Whether the Department has established that petitioner's deficiency is due to
20 negligence or intentional disregard for the Sales and Use Tax Law. We conclude that it has.

21 The Department asserted the negligence penalty because petitioner had incomplete records,
22 lacked internal controls, was audited twice before, and its level of underreporting during this audit
23 period was 109 percent. Additionally, petitioner did not keep numbered invoices, a sales journal had
24 to be recreated during the audit, resale certificates were not properly maintained, and petitioner did not
25 maintain purchase invoices. In the previous audit, the percentage of understatement was 33 percent,
26 and the negligence penalty was applied and upheld.

27 Petitioner explains that in the prior audit period an accountant was employed to do the taxes. In
28 this audit, petitioner could not afford an accountant and did not have complete records to give an

1 accountant to prepare its tax returns. Petitioner notes that, unlike the prior audit period, there were no
2 disallowed exempt or nontaxable sales in this audit period. Petitioner asserts that the audited liability
3 is “built on a house of cards” and, “were common sense to prevail, there would be no liability.”
4 Petitioner asserts there was no negligence.

5 Taxpayers are required to maintain and make available for examination all records necessary to
6 determine the correct tax liability and records necessary for the proper completion of the sales and use
7 tax return. (Rev. & Tax. Code, § 7053; Cal. Code Regs., tit. 18, § 1698, subd. (b)(1).) Failure to
8 maintain and keep complete and accurate records is evidence of negligence and may result in penalties.
9 (Cal. Code Regs., tit. 18, § 1698, subd. (k).) Petitioner’s failure to maintain a general ledger,
10 prenumbered sales invoices, a contemporaneous sales journal, or a purchase journal was completely
11 inadequate. Petitioner’s failure to maintain records forced the Department to employ a bank deposit
12 analysis to determine total sales. Considering petitioner was audited twice before, we find that it was
13 fully aware of its obligation to maintain the records necessary to determine its tax liability. Further,
14 based on the determined tax (which we believe is less than the actual understatement), petitioner
15 underreported taxable sales by 109 percent. We thus find that petitioner’s tax liability was the result of
16 negligent or intentional disregard for the Sales and Use Tax Law.

17 **Issue 3:** Whether petitioner is entitled to relief from interest due to unreasonable delay by
18 Board staff. We conclude that there was no unreasonable delay by Board staff and that relief is not
19 warranted.

20 The imposition of interest is mandatory (Rev. & Tax. Code, §§ 6482, 6591), and the law
21 provides for relief of interest only under very narrow circumstances, such as when the failure to make a
22 timely return or payment was due to a disaster, unreasonable error or delay by a Board employee, or
23 reasonable reliance on written advice from the Board. (Rev. & Tax. Code, §§ 6593, 6593.5, 6596.) A
24 person must file with the Board a statement under penalty of perjury setting forth the facts upon which
25 he or she bases his or her claim for relief. (Rev. & Tax. Code, §§ 6593, 6593.5, 6596.)

26 Petitioner has submitted an unsigned statement requesting relief from interest based on
27 unreasonable delay by Board staff. The statement indicates that the “audit started in July 2003 and was
28 not completed until July 2005. We provided support for the bank deposit problem, but the audit

1 dragged on for over two years. It also took over a year and a half – October 2005 when I filed the
2 Petition for Redetermination – to April 2007 when you held the Appeals Conference.”

3 We note that the Assignment Contact History in the audit work papers indicates that the auditor
4 first called petitioner to make an appointment on September 4, 2002. Thereafter, petitioner made
5 numerous requests for delays to obtain an accountant and to gather its records. After multiple
6 postponements at petitioner’s request, the auditor first met petitioner’s representative on
7 September 25, 2003, at which time, petitioner stated it needed additional time to produce records for
8 the audit. At a November 4, 2003, meeting, petitioner delivered “a large portion of the records.” The
9 field work on the audit started in February 2004 and continued through the end of that year. The audit
10 was completed in February 2005 and was discussed with petitioner in March 2005. The audit was
11 submitted for review in April 2005, and another audit discussion was held with petitioner in June 2005.
12 A revised audit was issued in July 2005, completed in August 2005, discussed with petitioner in
13 September 2005 and submitted for review and transmitted in October 2005. The case was sent to the
14 Petitions Section in November 2005. The Petitions Section reviewed the appeal and prepared a
15 Summary Analysis. The case was sent to the Appeals Division in March 2006 and in January 2007 the
16 case was assigned for an appeals conference, which was held on April 4, 2007.

17 The auditor was forced to use alternative methods of estimating petitioner’s sales because
18 petitioner did not have records of its own sales. The Department asserts that petitioner continued
19 providing new information regarding the bank deposits and exempt sales during all phases of the audit
20 including the discussion phase and the appeals phase. We can confirm that petitioner continued to
21 provide schedules and assertions regarding the bank deposit analysis after the appeals conference was
22 held.

23 We conclude that most of the delays in the completion of this audit and the subsequent appeal
24 are of petitioner’s own making. Petitioner cannot request lengthy delays in conducting the audit,
25 provide incomplete records, provide new information during all phases of the audit and appeals
26 process, and then receive relief from interest because the audit dragged on too long. We find that there
27 was no unreasonable delay on the part of Board staff and that petitioner is not entitled to any relief of
28 interest.

AMNESTY

Petitioner did not apply for amnesty. Since the determination was issued after the amnesty period, the determination included a double amnesty negligence penalty in the amount of \$3,987. (Rev. & Tax. Code, § 7073 subd. (c).) Additionally, an amnesty interest penalty of \$6,082.55 will apply when the determination is final. (Rev. & Tax. Code, § 7074, subd. (a).) Petitioner has submitted a request for relief from the amnesty penalties, signed under penalty of perjury, declaring that the audit and the appeals process have been unnecessarily long. Petitioner declares that if the audit and appeal had been completed in a timely manner, the petition most likely would have been completed prior to the deadline for applying for amnesty. Petitioner stated it did not participate in the amnesty program because it expected to prevail on the merits of the petition and also because petitioner did not have the funds to pay the tax.

We find that none of petitioner's explanations provide a justification for failure to participate in the amnesty program. Even if there were unreasonable delay in completing the audit or processing appeal, it does not provide reasonable cause for petitioner to have failed to participate in the amnesty program. Similarly, petitioner's avowed belief that it would prevail on the merits of its appeal does not provide reasonable cause for failing to participate in the amnesty program. The purpose of the amnesty program was for taxpayers to pay their tax deficiencies, *including* those subject to pending appeals. Thus, we find that petitioner's failure to file for amnesty or pay the audit liability by March 31, 2005, the deadline for applying for amnesty, was not due to circumstances beyond petitioner's control. Accordingly, we conclude that there is no basis for relief of the amnesty penalties.

OTHER DEVELOPMENTS

Petitioner filed a Request for Reconsideration reiterating its prior arguments, and we issued a Supplemental Decision and Recommendation rejecting petitioner's contentions.

Summary prepared by John K. Chan, Business Taxes Specialist I