

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 MICHAEL DONOVAN THOMPSON,) Account Number: SR AR 99-251499
 6 dba Petroleum Equipment & System Sales) Case ID 381893
 7 Petitioner) Simi Valley, Ventura County

8 Type of Business: Petroleum equipment retailer

9 Audit Period: 07/01/01 – 12/31/05

10 <u>Items</u>	<u>Amounts in Dispute</u>	
11 Unreported taxable sales	\$3,549,872	
12 Unexplained differences of bank deposits	\$2,135,510	
13 Fraud penalty	\$113,799	
14 Amnesty double fraud penalty	\$27,250	
15 Amnesty interest penalty	\$12,092	
	<u>Tax</u>	<u>Penalties</u>
16 As determined	\$468,537.57	\$144,384.30
17 Adjustment: Appeals Division	<u>-13,342.16</u>	<u>-3,335.48</u>
18 Proposed redetermination, protested	<u>\$455,195.41</u>	<u>\$141,048.82</u>
19 Proposed tax redetermination	\$455,195.41	
20 Interest through 11/30/09	239,631.30	
21 Fraud penalty	113,799.03	
22 Amnesty double fraud penalty	27,249.79	
23 Amnesty interest penalty	<u>12,092.07</u>	
24 Total tax, interest, and penalties	\$847,967.60	
25 Payments	<u>-326.90</u>	
26 Balance due	<u>\$847,640.70</u>	
27 Monthly interest beginning 12/1/09	<u>\$3,032.46</u>	

23 Petitioner had submitted a settlement proposal prior to the scheduled appeals conference, and
 24 declined to participate in the appeals process while his settlement proposal was pending. Pursuant to
 25 the policy that matters in settlement are delayed only for the Board hearing (to prevent the Board
 26 Member involvement in the case that would preclude a settlement), we held the conference as
 27 scheduled, and thereafter sent petitioner a letter giving him an opportunity to submit any additional
 28 documentation that he would like us to consider in this matter. Petitioner did not respond, and we thus

1 prepared the Decision and Recommendation without the benefit of his additional input. The matter
2 was not settled, and pursuant to petitioner's previous request, the appeal was scheduled for Board
3 hearing on September 22, 2009. However, petitioner did not respond to the Notice of Hearing, and the
4 Board Proceedings Division thus informed petitioner that this matter will be presented to the Board for
5 decision without oral hearing. The matter was pulled from the consent calendar by Chairwoman Betty
6 Yee.

7 UNRESOLVED ISSUES

8 **Issue 1:** Whether adjustments to the audited tax liability are warranted. We recommend no
9 adjustments.

10 During the audit, the Sales and Use Tax Department (Department) found that petitioner's
11 records were inadequate for sales and use tax audit purposes. Petitioner only provided federal income
12 tax returns (FITR's) for 2002, 2003, and 2004; copies of bank statements for the period July 1, 2002,
13 through September 30, 2005; sales invoices for the first six months of 2005; and purchase invoices
14 from January 1, 2005, through September 30, 2005. Consequently, the Department contacted
15 petitioner's known vendors in order to obtain purchase invoices. Only purchase invoices for the period
16 January 1, 2003, through December 31, 2005, were available from vendors. The Department
17 compared amount of purchases per vendors' records with petitioner's reported taxable sales, and found
18 that purchases of \$2,762,127 per vendors' records for the years 2003 through 2005 exceeded reported
19 taxable sales of \$785,264 for the same period, by \$1,976,863 (\$2,762,127 - \$785,264).

20 Based on this discrepancy, the Department decided to establish petitioner's taxable sales by the
21 markup method. First, the Department performed shelf tests for each known vendor for the period
22 January 1, 2005, through June 30, 2005, establishing a weighted markup of 15.35 percent. The
23 weighted markup was applied to audited purchases resulting in audited taxable sales of \$897,057 for
24 2003, \$1,019,371 for 2004, and \$1,269,685 for 2005. Upon comparison to reported taxable sales of
25 \$173,129 for 2003, \$161,538 for 2004, and \$450,597 for 2005, understatements of \$723,928 for 2003,
26 \$857,833 for 2004, and \$819,088 for 2005, which equals an error ratio of 418.14 percent for 2003,
27 531.04 percent for 2004, and 181.78 percent for 2005, were established. To establish the
28 understatement for the period July 1, 2001, through December 31, 2002, the error rate of

1 418.14 percent from 2003 was applied to reported taxable sales for these periods, resulting in
2 understated taxable sales of \$388,096 for July 1, 2001, through December 31, 2001, and \$760,927 for
3 2002. In sum, the Department established that petitioner understated its taxable sales by \$3,549,872
4 for the audit period.

5 The Department also examined petitioner's bank deposits and found total bank deposits of
6 \$8,754,577 for the period April 1, 2002, through December 31, 2005. This was adjusted for audited
7 repair and installation labor of \$1,182,572, and returns and other non-sales revenue of \$1,065,443,
8 resulting in excess bank deposits of \$6,506,562. Petitioner has no reasonable explanation for this
9 excess bank deposits. Thus, the Department considered the excess bank deposits as taxable sales
10 including tax. Adjusting for sales tax included, taxable sales of \$6,066,724 were established and when
11 compared to reported taxable sales of \$929,067, understated taxable sales of \$5,137,657 were
12 established. The Department calculated that \$3,002,146 of the \$5,137,657 represents additional
13 taxable sales established using the markup method for the period April 1, 2002, through December 31,
14 2005, and the remaining \$2,135,511 represents taxable sales in excess of the additional sales
15 established by the markup analysis. It should be noted that, since there were no bank statements for
16 the period April 1, 2001, through December 31, 2001, the Department did not establish a liability for
17 this period based on excess bank deposits.

18 Petitioner contends that the measure of tax is excessive because his estimated mark-up on
19 equipment sales to gas stations is between five and eight percent, not the weighted markup of
20 15.35 percent used by the Department; the bank deposit analysis includes non-sales amounts such as
21 personal loan payments and other items not associated with sales of tangible personal property; and the
22 audit calculations did not allow for bad debts.

23 With respect to the markup method, we note that the markups were computed in the audit based
24 on factual information from purchase invoices and markups disclosed by petitioner's own recorded
25 selling prices. We have reviewed the audit computations and have found no inherent flaws or
26 inaccuracies in the audit presumptions and procedures. Moreover, petitioner has provided no evidence
27 that the markup percentage calculated by the Department is inaccurate or provided any evidence that is
28 more reliable than the evidence relied upon by the Department in computing the markup calculations.

1 Therefore, we conclude that no adjustment is warranted for this contention to the measure of
2 understated taxable sales based on the markup method.

3 With respect to the excess bank deposits, petitioner has not provided documentation to verify
4 that any excess gross receipts were non-sales items. Absent additional evidence from which a new and
5 better determination may be made, there is no basis on which to conclude that petitioner's excess bank
6 deposits included funds derived from nontaxable transactions, nor can we calculate the amount of such
7 alleged transactions. As a result, we are unable to recommend an adjustment to the measure of tax
8 based on excess bank deposits.

9 With respect to bad debts, a retailer is relieved from liability for sales tax that became due and
10 payable, insofar as the measure of the tax is represented by accounts that have been found to be
11 worthless and that the retailer has charged off for income tax purposes or, if the retailer is not required
12 to file income tax returns, that the retailer has charged off in accordance with generally accepted
13 accounting principles, provided that the sales tax was actually paid to the state. (Rev. & Tax. Code, §
14 6055, Cal. Code Regs., tit. 18, § 1642.) Petitioner has not provided any supporting documentation to
15 prove that he is entitled to bad debt deductions and he did not take any bad debt deductions on his
16 FITR's. Moreover, since a bank deposit analysis was used to determine audited taxable sales,
17 adjustments for returned checks for insufficient funds were included in the bank statement calculations
18 examined by the Department. Therefore, absent additional evidence, we are unable to recommend any
19 adjustments for bad debts.

20 **Issue 2:** Whether there is clear and convincing evidence of fraud or intent to evade the tax.

21 We conclude that there was fraud or intent to evade the tax and that imposition of the fraud penalty is
22 warranted.

23 Petitioner claims that the tax liability calculated by the Department is overstated. Petitioner
24 states that he did not intend to defraud the state or to evade paying taxes, and asserts, instead, that he
25 was negligent in reporting sales to the Board.

26 Petitioner's knowledge of the application of sales tax is reflected by the fact that he included
27 and collected sales tax reimbursement on retail sales. He then signed and filed sales and use tax
28 returns during the audit period, remitting only a portion of the sales tax reimbursement to the Board.

1 In fact, he consistently and significantly understated tax reimbursement that he collected from his
2 customers, reporting tax measured by \$1,060,058 and understating tax measured by \$5,851,630, which
3 is an understatement of 552 percent ($\$5,851,630 \div \$1,060,058$).

4 In addition, petitioner did not maintain adequate and complete records, and failed to provide
5 any cancelled checks, and only a portion of purchase invoices and sales invoices for examination by
6 the Department. Petitioner claimed that he threw away most of his records such that no records prior
7 to January 1, 2005, were available for examination. We believe that petitioner's failure to maintain
8 adequate records shows his attempt to evade the tax by concealing assets from examination.
9 Consequently, based on the totality of the evidence, we find that the substantial underreporting, and
10 inadequate books and records is the clear and convincing evidence of fraud necessary to support the
11 assessment of the fraud penalty.

12 AMNESTY

13 Petitioner did not timely apply for amnesty, or pay the tax due for the amnesty-eligible
14 reporting period July 1, 2001, through December 31, 2002, by March 31, 2005, as required by the tax
15 amnesty program. (Rev. & Tax. Code, § 7073, subd. (a).) Thus, the Department assessed an
16 additional penalty of \$27,249.79 under Revenue and Taxation Code section 7073, subdivision (c),
17 which doubled the 25-percent fraud penalty for that portion of the liability that had been eligible for
18 amnesty, for petitioner's failure to report the tax due for amnesty-eligible periods. Additionally, a 50
19 percent amnesty interest penalty of \$12,092.07 will apply when the amnesty eligible liability becomes
20 final. (Rev. & Tax. Code, § 7074, subd. (a).)

21 We advised petitioner by letter dated March 14, 2008, that even though he believed that it was
22 not appropriate to participate or present any contentions for relief during the appeals process while
23 going through settlement, he could submit additional documentation for our consideration should he
24 reconsider his position. However, petitioner has not responded, and has not submitted a request for
25 relief of these penalties. Therefore, we have no basis to consider recommending relief of these
26 penalties.

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RESOLVED ISSUE

The Notice of Determination included an audit deficiency item measured by \$166,248 for disallowed claimed nontaxable repair and installation labor based on a comparison between amounts claimed on petitioner’s sales and use tax returns and amounts reported on his federal income tax returns for 2002, 2003, and 2004 for the cost of contracted repair and installation labor. In our Supplemental Decision and Recommendation, we recommended this item be removed because virtually all of such amounts had already been included in the measure of tax as unexplained taxable bank deposits.

OTHER DEVELOPMENTS

None.

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