

**CALIFORNIA STATE BOARD OF EQUALIZATION  
APPEALS DIVISION BOARD HEARING SUMMARY**

In the Matter of the Petition for Redetermination )  
 Under the Sales and Use Tax Law of: )  
 PUBLIC MOTORS ORANGE COUNTY, LLC ) Account Number SR EA 100-344312  
 ) Case ID 569627  
 Petitioner ) Santa Ana, Orange County

Type of Business: Used car dealer  
 Audit period: 04/01/05 – 03/31/08

<u>Item</u>	<u>Disputed Amount</u>		
Unreported taxable sales	\$6,757,253		
Purchases of supplies subject to use tax	\$ 43,571		
Purchases of assets subject to use tax	\$ 180,953		
Negligence penalty	\$ 55,074		
		<u>Tax</u>	<u>Penalty</u>
As determined		\$ 580,219.96	\$122,266.48
Post-D&R adjustments		- 29,481.70	- 67,192.65
Proposed redetermination, protested		<u>\$ 550,738.26</u>	<u>\$ 55,073.83</u>
Proposed tax redetermination		\$ 550,738.26	
Interest through 01/31/17		394,598.58	
Negligence penalty		<u>55,073.83</u>	
Total tax, interest, and penalty, balance due		<u>\$1,000,410.67</u>	
Monthly interest beginning 02/01/17		<u>\$ 2,753.69</u>	

This appeal involves an amount in controversy that is \$500,000 or more and thus is covered by Revenue and Taxation Code section 40, as explained below.

This matter was scheduled for Board hearing in July 2014, but it was deferred at the request of the Appeals Division in order to issue a Supplemental Decision and Recommendation (SD&R). It was rescheduled for Board hearing in December 2015, but it was postponed for settlement consideration.

**UNRESOLVED ISSUES**

**Issue 1:** Whether any further adjustments to the amount of unreported taxable sales are warranted. We find that no further adjustments are warranted.

Petitioner operated a used car dealership from September 2004 until December 2015. Petitioner made retail sales of used vehicles by holding a public auction every Sunday, and also made

1 retail sales to customers who visited its retail vehicle lot. For audit, petitioner provided general  
2 ledgers, federal income tax returns (FITR's), and vehicle deal jackets for February 2007. The Business  
3 Tax and Fee Department (Department), formerly the Sales and Use Tax Department, noted that gross  
4 receipts reported on petitioner's FITR's substantially exceeded reported total sales on the sales and use  
5 tax returns. The Department scheduled sales tax reimbursement recorded in the general ledgers and  
6 reduced that amount by the amount of sales tax reimbursement accrued on sales that were reversed  
7 (unwinds). The Department found that sales tax reimbursement accrued in the general ledgers  
8 exceeded sales tax paid on petitioner's sales and use tax returns by \$371,411, which represented  
9 unreported taxable sales of \$4,706,170. The Department also determined that eleven general ledger  
10 accounts represented recorded taxable sales, which totaled \$40,074,701 and exceeded reported taxable  
11 sales by \$6,807,501. To avoid duplications, the Department reduced this amount by the amount of  
12 unreported taxable sales established based on sales tax reimbursement collected, and established  
13 additional unreported taxable sales of \$2,101,332 (rounded). In the post-D&R reaudit, this amount  
14 was reduced by \$147,589 because it was determined that general ledger account no. 4140 (forfeit fees)  
15 did not involve taxable sales of tangible personal property. We also noted that the Department had  
16 erroneously compared recorded taxable sales to reported taxable measure, which included reported  
17 purchases subject to use tax of \$97,342. Thus, the amount of additional unreported taxable sales was  
18 reduced to \$2,051,083 (rounded) ( $\$2,101,332 - \$147,589 + \$97,342$ ) in the post-D&R reaudit. In total,  
19 the Department established unreported taxable sales of \$6,757,253 ( $\$4,706,170 + \$2,051,083$ ) in the  
20 post-D&R reaudit.

21         Petitioner contends that additional adjustments are warranted for unwinds. Petitioner also  
22 contends that unreported taxable sales should be reduced to allow for bad debts. To support an  
23 adjustment for bad debts, petitioner provided a worksheet in which it computed bad debts of  
24 \$95,998.35 related to 550 sales of used vehicles.

25         We note that petitioner has not provided any documentation or other evidence to demonstrate  
26 that it is entitled to additional adjustments for unwinds, and thus, we recommend no adjustment. With  
27 respect to bad debts, we note that petitioner claimed a bad debt of \$2,209 on its FITR for 2006, but did  
28 not provide any documentation to show that this amount related to a taxable transaction. While

1 petitioner provided a worksheet showing other bad debts, it did not provide any documentary evidence  
2 showing that any of the transactions listed on the worksheet were charged off as bad debts for income  
3 tax purposes in accordance with California Code of Regulations, title 18, section (Regulation) 1642,  
4 subdivision (e)(7). In the absence of sufficient evidence to support bad debt losses from taxable sales,  
5 we recommend no adjustment for bad debts. Accordingly, we recommend no further reduction to the  
6 measure of unreported taxable sales.

7 **Issue 2:** Whether any further adjustments to the amount of unreported purchases of consumable  
8 supplies subject to use tax are warranted. We find that no further adjustments are warranted.

9 The Department noted that petitioner reported use tax on purchases totaling \$97,342 on its sales  
10 and use tax returns during the period April 1, 2005, through December 31, 2005. While the  
11 Department found that petitioner likely made additional ex-tax purchases of consumable supplies  
12 subject to use tax in other quarterly periods, it found that it was required to estimate the amount of the  
13 ex-tax purchases because petitioner did not provide any purchase invoices for the audit period. Based  
14 on its experience in similar audits, the Department estimated that petitioner owed use tax on 20 percent  
15 of its purchases of consumable supplies. The Department applied its estimated ex-tax purchase ratio of  
16 20 percent to total recorded consumable supply purchases of \$768,386 for the period January 1, 2006,  
17 through March 31, 2008, to compute unreported ex-tax purchases of consumable supplies subject to  
18 use tax of \$153,677 for the period January 1, 2006, through March 31, 2008. For the period April 1,  
19 2005, through December 31, 2005, the Department accepted the accuracy of petitioner's reported  
20 purchases subject to use tax.

21 After the appeals conference, petitioner provided some purchase invoices for the year 2007.  
22 Based on the available purchase invoices, the Department recommended reducing the ratio of  
23 consumable supply purchases subject to use tax from 20 percent to 5.67 percent of petitioner's  
24 recorded purchases of consumable supplies. In the post-D&R reaudit, unreported consumable supply  
25 purchases subject to use tax were reduced by \$110,108 to \$43,571.

26 Petitioner contends that it paid tax on all of its purchases of consumable supplies, and thus, the  
27 measure of tax should be reduced to zero.

1 We note that petitioner self-reported purchases subject to use tax totaling \$97,342 on its sales  
2 and use tax returns for the period April 1, 2005, through December 31, 2005. Thus, we find that  
3 petitioner did not pay tax to its vendors on all of its purchases of consumable supplies. The  
4 Department's concession that the ex-tax purchase ratio should be reduced to 5.67 percent of total  
5 recorded purchases is based on its review of the purchase invoices the petitioner provided for the year  
6 2007. Petitioner has not provided any additional purchase invoices to show that tax was paid to its  
7 vendors on all of the remaining purchases of supplies, and has not provided any other evidence to  
8 support an additional reduction. Thus, we recommend no additional reduction to the measure of tax  
9 for unreported purchases of consumable supplies subject to use tax.

10 **Issue 3:** Whether any further adjustments to the amount of unreported purchases of capital  
11 assets subject to use tax are warranted. We find that no further adjustments are warranted.

12 Using petitioner's depreciation schedules from its federal income tax returns, the Department  
13 scheduled capital asset purchases totaling \$181,953. Since petitioner failed to provide any purchase  
14 invoices, the Department concluded that petitioner owed use tax on all of the purchases of capital  
15 assets. Based on its examination of purchase invoices provided by petitioner after the appeals  
16 conference, the Department reduced unreported capital asset purchases subject to use tax by \$1,000,  
17 from \$181,953 to \$180,953, in the post-D&R reaudit.

18 Petitioner contends that a purchase of a capital asset for \$140,649 on March 31, 2006, shown in  
19 its depreciation schedules is computer equipment and software that it does not own, and therefore, it  
20 does not owe use tax on the purchase. According to petitioner, the computer equipment and software  
21 is owned by PBS Financial Systems, Inc., a company located in Canada. Petitioner provided a copy of  
22 a contract dated January 4, 2006, for the purchase of computer equipment and software for a total of  
23 \$52,642, which it contends represents a portion of the asset purchase of \$140,649.

24 We have reviewed the contract provided by petitioner and we note that the contract is for  
25 petitioner's purchase of computer equipment, software license, and hardware/software maintenance for  
26 a lump-sum price of \$52,642, excluding taxes and freight. Petitioner has neither provided evidence to  
27 show that sales or use tax was paid on the purchase, nor provided any evidence to determine whether  
28 the hardware/software maintenance contracts were exempt from tax. Regarding petitioner's contention

1 that the equipment is owned by PBS, Financial Systems, Inc., we find that the fact that petitioner  
2 depreciated the equipment is strong evidence that petitioner purchased the equipment. Furthermore,  
3 petitioner has not provided any additional invoices to show that tax was paid on any of the remaining  
4 asset purchases. Based on the foregoing, we recommend no additional adjustments.

5 **Issue 4:** Whether petitioner was negligent. We conclude that it was.

6 As explained in resolved issues, the Department original imposed the 40-percent penalty  
7 evasion penalty on a portion of the liability in which petitioner collected sales tax reimbursement from  
8 its customers and failed to remit to the state, which was later reduced to the negligence penalty. The  
9 Department imposed the negligence penalty because petitioner failed to properly report sales recorded  
10 in its own records, and failed to maintain complete sales contracts and purchase invoices to support  
11 amounts recorded in its general ledger.

12 We find that petitioner's failure to provide complete sales contracts and purchase invoices for  
13 the entire audit period is strong evidence of negligence in recordkeeping. Also, recorded taxable sales  
14 exceeded reported taxable sales by \$6,757,253, and sales tax reimbursement accrued in the general  
15 ledgers exceeded sales tax paid on petitioner's sales and use tax returns by \$371,411 (tax), which is  
16 strong evidence of negligence in reporting. A comparison of unreported taxable sales of \$6,757,253  
17 with reported taxable sales of \$33,169,858 shows a reporting error rate of 20.37 percent. We find that  
18 petitioner's bookkeeping and reporting errors (the absence of complete records, the magnitude of the  
19 understatement, the fact that reported taxable sales were substantially less than recorded taxable sales  
20 and petitioner failed to report \$371,411 in sales tax reimbursement recorded in its general ledgers)  
21 cannot be attributed to its bona fide and reasonable belief that its bookkeeping and reporting practices  
22 were sufficiently compliant with the requirements of the Sales and Use Tax Law. (*Cf. Independent*  
23 *Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 321-324.) Accordingly, we  
24 conclude that petitioner was negligent and the penalty was properly imposed.

#### 25 **RESOLVED ISSUES**

26 The Department established a separate measure of tax representing unreported taxable sales of  
27 \$214,179 based on a beginning balance of \$16,903 in petitioner sales tax accrual account on April 1,  
28 2005. Petitioner asserted that the Department was barred by the statute of limitations from including

1 the measure of tax for unreported taxable sales of \$214,179, because the sales occurred prior to April  
2 1, 2005.

3 We conclude that the beginning balance in petitioner's sales tax accrual account on April 1,  
4 2005, resulted from taxable sales that occurred prior to April 1, 2005. There is no dispute that the  
5 statute of limitations has expired for periods prior to April 1, 2005. Thus, we recommended that  
6 unreported taxable sales of \$214,179 be deleted.

7 The Department applied the 40-percent evasion penalty on sales tax reimbursement of  
8 \$214,148.12 that petitioner collected from its customers and failed to remit to the state during the  
9 period April 1, 2007, through December 31, 2007. Petitioner asserted that the understatement was the  
10 result of employee turnover and not the intent to defraud the state.

11 After the post-D&R reaudit, the Department concluded that there was not clear and convincing  
12 evidence that petitioner intended to evade remittance of the sales tax reimbursement it collected, and  
13 recommended that the 40-percent penalty be deleted and replaced with the 10-percent penalty for  
14 negligence. We concur with the Department's recommendation.

#### 15 **OTHER MATTERS**

16 None.

#### 17 **SECTION 40 MATTER**

18 As noted above, this matter is subject to Revenue and Taxation Code section 40. Therefore,  
19 within 120 days from the date the Board's vote to decide the appeal becomes final, a written opinion  
20 (i.e., Summary Decision or Memorandum Opinion) must be published on the Board's website. (Cal.  
21 Code Regs., tit. 18, § 5552, subs. (b), (f).) The Board's vote to decide the appeal will become final 30  
22 days following the date on which notice of the Board's decision is mailed to the parties, except when a  
23 petition for rehearing is filed within that period.<sup>1</sup> (Cal. Code Regs., tit. 18, § 5561, subd. (a).)

24 Following the conclusion of this hearing, if the Board votes to decide the appeal, but does not  
25 specify which type of written opinion should be prepared, staff will expeditiously prepare a  
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28 <sup>1</sup> If a petition for rehearing is filed, the Board's decision will not become final, and no written opinion under Section 40 will  
be considered until after the petition for rehearing is resolved.

1 nonprecedential Summary Decision and submit it to the Board for consideration at a subsequent  
2 meeting. (Cal. Code Regs., tit. 18, § 5551, subd. (b)(2).) The proposed written opinion would not be  
3 confidential pending its consideration by the Board (Cal. Code Regs., tit. 18 § 5551, subd. (b)(5));  
4 accordingly, it would be posted on the Public Agenda Notice for the meeting at which the Board will  
5 consider and vote on the written opinion.

6 Any party may request that the Board delay voting to decide the appeal until it votes to adopt  
7 its written opinion for the appeal. Any such request should be made in writing to the Board  
8 Proceedings Division prior to the hearing or as part of the party's oral argument at the hearing, and the  
9 request would then be considered by the Board during its deliberations on the appeal. If the Board  
10 grants the request, the proposed written opinion will be confidential until it is adopted by the Board.  
11 (Cal. Code Regs., tit. 18, § 5551, subd. (b)(5).)

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14 Summary prepared by Gary A. Lomazzi, Business Taxes Specialist III  
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