

**Memorandum**

**To** : Mr. Ramon J. Hirsig  
Executive Director (MIC 73)

**Date:** July 30, 2008

**From** : Ms. Randie J. Henry, Deputy Director  
Sales and Use Tax Department (MIC 43)



**Subject** : **Proposed Revisions to Audit Manual Chapter 4, General Audit Procedures, and Chapter 5, Penalties**

In accordance with the established procedures for audit and compliance manual revisions, I am submitting the following proposed revisions to Audit Manual Chapter 4, *General Audit Procedures*, and Chapter 5, *Penalties*, for your approval to forward to the Board Proceedings Division. These changes have been reviewed and approved by SUTD management, provided to Board Members, and posted at <http://www.boe.ca.gov/sutax/staxmanuals.htm> to solicit comments from interested parties since April 22, 2008.

We received no comments from the public. On July 7, 2008, we sent a memo advising Board Members that there were no comments and of our intention to place these revisions on the August 20, 2008 Administrative Agenda as a consent item.

The proposed revisions are attached for your reference. We request your approval to forward these revisions to the Board Proceedings Division for placement on the next Administrative Agenda as a consent item.

If you have any questions, please let me know or contact Mr. Jeff McGuire at 324-1825.

Approved:

  
\_\_\_\_\_  
Ramon J. Hirsig  
Executive Director

Attachment

Mr. Ramon J. Hirsig  
Executive Director (MIC 73)

-2-

July 30, 2008

cc: (all without attachment)  
Mr. Stephen Rudd (MIC 46)  
Ms. Freda Orendt (MIC 47)  
Mr. Jeff McGuire (MIC 92)  
Mr. Bob Buntjer (MIC 49)  
Ms. Kelly Reilly (MIC 47)  
Mr. Geoff E. Lyle (MIC 50)  
Ms. Nini McCormack (MIC 50)  
BTCT Files – AM Revisions

BOARD APPROVED  
At the August 20, 2008 Board Meeting

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Diane Olson, Chief  
Board Proceedings Division

## **Audit Manual Chapter 4, General Audit Procedures**

### **Summary of Revisions**

#### **AM Section**

- 0401.20 Moves information from this section to AM sections 0213.03, 0408.20 or 0408.22, as appropriate, for better organization of procedures. AM section 0213.03 revision will be processed at a later time.
- 0403.10 Lists the various types of engagement letters (Form BOE-80 Series) and explains the use of BOE-80-RU, *Record Updates*.
- 0405.33 Allows the use of the prior audit percentage of error in a current audit with only one prior audit. Delegates the approval of the use of the prior audit percentage of error to the District Principal Auditors. Revision is based on Tax Policy Division memo dated 2/9/06.
- 0408.20 Updates procedures for preparing Form BOE-1164, *Audit Memorandum of Possible Tax Liability*.
- 0408.22 Updates procedures for preparing Form BOE-1032, *Information on Out-Of-State Retailers*.
- 0410.15 Updates the list of banks that issue credit cards for use by the Federal Government employees, based on current General Services Administration (GSA) website and information from GSA staff.
- 0419.17 Updates procedures for bad debts incurred by lenders based on Tax Policy Division memos dated 12/27/05 and 6/23/06.
- 0435.20 Updates audit procedures for the Managed Audit Program based on Tax Policy Division memo dated 5/12/06 memo and draft of suggested text for AM 0435.20.

#### **Exhibits**

- 6 Updates prior audit percentages of error memos.
- 9 Inserts Form BOE-504-BPA, *Sample Letter for Special Printing Aids*.
- 15 Updates position title for the Chiefs, Field Operations Division.
- 5, 8, 9, & 14B Updates names of Board Members.

## GENERAL AUDIT PROCEDURES

0400.00

### INTRODUCTION

0401.00

#### GENERAL

0401.05

It is not the purpose of this manual to lay down rules so rigid the auditor is precluded from the exercise of reasonable judgment. Suggested procedures that conform to standard audit practices are presented with an explanation of the terms frequently used by ~~tax~~ auditors. The auditor should recognize, however, that there are many variations necessitated by application of the law, rules and regulations, taxpayer's methods of reporting, and types of records encountered. For these reasons, it is impractical to present procedures that will be applicable to all situations. The typical flow of the audit process is illustrated in Exhibit 1.

Specific reference is made to the glossary contained in Audit Manual (AM) section 0490.00 for terms peculiar to tax auditing which are used in this chapter. The auditor is expected to have a good working knowledge of these terms. It is suggested that the auditor be familiar with the terms in the glossary prior to reading this chapter.

#### OBJECTIVE OF THE TAX AUDIT

0401.10

The primary objective of the tax audit is to determine, with the least possible expenditure of time, the correct measure of tax. The audit program also provides information and assistance to taxpayers, enabling them to complete returns and pay ~~their~~ taxes correctly and efficiently. Interpretations of the law and related regulations, ~~which are obtained by taxpayers during the audit process, provide them taxpayers with the a basis for the proper reporting basis or method of for reporting future tax liabilities.~~

#### AUDIT SELECTION

0401.15

Each district ~~has theis~~ responsibility ~~of for~~ determining which accounts are to be audited.

~~The assignment of a~~ An audit assignment does not always result in a completed audit. Preliminary testing (AM section 0403.25) may disclose that an audit is not warranted, ~~in which case T~~ the auditor will prepare a ~~Form BOE-596, Report on Account Being Waived for Audit, on such accounts. Additional information on Form BOE 596 is included in (AM~~ section 0212.00).

When deciding whether to waive or perform an audit ~~an account~~, the auditor should consider the following points:

- Are accurate and complete records kept?
- Does the markup on cost of goods sold appear adequate?
- Are the persons preparing tax returns familiar with the law and the rules and regulations pertaining to their particular business?
- Are the reported amounts reasonable considering the type of business,

nature of the premises, the location in the community, etc.?

- Do the reported amounts vary materially from period to period?
- Is there a good system of internal control?
- Is the taxpayer's past record good?

When working on an audit assignment, the auditor may discover other accounts which may not have reported the correct amount of tax correctly. Such information should be communicated to the audit supervisor.

## **FORM BOE-1164 AND FORM BOE-1032**

**0401.20**

~~An~~ The auditor should prepare ~~may discover information in a taxpayer's records which indicates that a supplier or customer may not be reporting tax correctly. If so, a~~ Form BOE-1164, *Audit Memorandum of Possible Tax Liability*, (Exhibit 2) or Form BOE-1032, *Information on Out-of-State Retailers* (Exhibit 3) in appropriate circumstances ~~should be prepared in duplicate setting forth the facts. The original, along with any supporting documents, is submitted to the audit supervisor and will be used as a basis for investigation; the duplicate remains with the working papers. The information on these forms is valuable in audit selection and may aid in disclosing tax that may otherwise remain unreported. Therefore, the importance of preparing these forms cannot be overemphasized. For information on the use of Form BOE-1164 and Form BOE-1032, see AM sections 0408.20 and 0408.22.~~

~~If the seller has accepted a properly executed resale or exemption certificate in good faith, and the auditor questions whether the buyer has in fact purchased the merchandise for resale, or in fact an exemption applies, the auditor should prepare a BOE 1164 and check the block "Seller has valid (resale)(exemption) certificate from buyer on file." The auditor must also attach a photocopy of that certificate to the BOE 1164.~~

~~When untaxed purchases subject to use tax from an unregistered out of state vendor are detected, the auditor should notify the Out of State District. Form BOE 1032, *Information on Out of State Retailers*, (Exhibit 3) is available for this purpose. The original is forwarded to the Out of State District; the duplicate remains with the working papers (section 0408.22). If the vendor is registered, the proper form would be the BOE 1164 and not the BOE 1032.~~

~~The importance of preparing audit memoranda cannot be overemphasized. It is valuable as an aid to audit selection and may aid in disclosing tax that would not otherwise have been paid. It is the duty of the auditor to prepare memoranda in appropriate circumstances.~~

~~The auditor should also be alert for activity in other business taxes for which the taxpayer may not have a permit.~~

~~As a courtesy to the district receiving an audit memorandum, the auditor should attach a copy of registration and audit information (TAR AI and AUD MC) from the system which contains necessary information for selecting and ordering an~~

~~audit on the account in question. This information may also be useful to the auditor preparing the memorandum regarding the transaction in question, i.e. start date or industry code of the purchaser or supplier in question in the case of a questioned sale for resale.~~

**Confidentiality of Form BOE-1164 and Form BOE-1032 Information.**

~~Current policy allows copies of Form BOE-1164s and Form BOE-1032s to be released to a taxpayers in certain situations (e.g., when a copy of the form is included in the audit working papers, when the taxpayer requests a copy of his or her file). However, these forms may only be released if the confidential information about another taxpayer is redacted out. Thus, seller information must be redacted when the form is provided to the buyer, and buyer information must be redacted when the form is provided to the seller. Any invoices that are attached to the Form BOE-1164 or Form BOE-1032 must also be redacted to remove confidential information.~~

~~The information to be redacted includes any information which might lead to the discovery of confidential taxpayer information such as the taxpayer's name, permit number, purchase order number, invoice number, dollar amount of purchase, any other date or comments, which might lead to the discovery of confidential information.~~

The auditor should also be alert for activity in other business taxes for which the taxpayer may not have a permit. See AM sections 0205.51, 0205.53, 0205.55, and 0205.57.

**AUDIT MEMORANDUMS CONCERNING STATE AGENCIES**

**0401.23**

The Department of Finance no longer audits state agencies and therefore no longer receives or takes action on audit memorandums. Therefore, the audit memorandums prepared by auditors which involve state agencies should be distributed in the same manner as other audit memorandums.

The Out-of-State District in auditing out-of-state businesses should question any sales or leases to the State of California. If they find sales or leases subject to use tax in which the tax was not billed to the State or reported by the retailer, such sales or lease receipts should be assessed in the audit. Special care should be taken to accurately assess applicable local and district taxes.

**AUTHORITY — EXAMINATION OF RECORDS & ISSUANCE OF SUBPOENAS 0401.25**

Government Code sections 15618 authorizes an auditor to examine records of the taxpayer and of persons doing business with the taxpayer. Revenue and Taxation Code (RTC) section 7054 provides additional authority for the examination of records pertaining to the sales and use tax. Similar provisions are found in other tax and fee programs administered by the Board.

Government Code section 15613 authorizes the Board to issue a subpoena for the attendance of witnesses or to produce books, records, accounts and papers.

By developing a good working relationship with the taxpayer, an auditor should rarely have to rely on a subpoena as a means of obtaining records. However, if a

taxpayer refuses to make requested records available, or places undue restrictions or conditions on their use, the auditor's supervisor should be consulted immediately. Once notified, the supervisor should request the necessary records from the taxpayer and explain to the taxpayer, either verbally or in writing, the relevance of the records being requested. If the taxpayer continues to deny access to necessary records, the District Principal Auditor should send a letter to the taxpayer detailing the specific records being requested and the relevance of the records, including a reasonable compliance date. If the taxpayer fails to comply with this request, the District Administrator may request the issuance of a subpoena duces tecum based on the specific records detailed in the District's previous letter.

Without a subpoena or the taxpayer's/representative's permission, under no circumstances should the auditor take it upon herself/himself to review, schedule, photocopy, or otherwise access information from files to which the taxpayer has "forbidden" access.

Requests for the issuance of subpoenas must be made by District Administrators and submitted to the Chief, Field Operations Division, Equalization Districts 1 and 2 and Out-of-State District, or the Chief, ~~Collections and Third District Field Operations Division, Equalization Districts 3 and 4 and Centralized Collection Section~~ for approval and forwarding to the Legal Department. When the Legal Department has prepared the subpoena, it will be forwarded to the requester with complete instructions for service. Further information concerning the subpoena process, authority and use is contained in Exhibit 4 — Policy and Procedure for Subpoena Requests.

### **Video and Audio Taping**

If the taxpayer insists on video or audio taping the auditor as a condition of making the records available, the Board may consider issuing a subpoena for the records.

An auditor should not consent to videotaping without discussing the request with his or her supervisor. Although there may be limited circumstances where videotaping is approved, generally if a taxpayer insists on videotaping the auditor as a precondition to the availability of the necessary books and records, the taxpayer has in effect refused to cooperate with the auditor ~~staff~~ and has not made the necessary records available as required by law. Under these circumstances, the subpoena process may be used to obtain the books and records.

Although the taxpayer may not make audio taping a precondition for disclosure of the necessary records, the Board will allow a taxpayer to audiotape audit discussions with the auditor provided the Board makes its own audio recording. Depending on the experience of the auditor and/or the nature of the audit issues, the district may want to consider having a supervisor present during the audio taping of the audit discussions.

## PUBLIC RELATIONS

0401.30

It is important that the auditor attempt to establish a good rapport with the taxpayer thereby encouraging a cooperative attitude.

The Board has established a basic policy which is clearly stated in AM Chapter 1, General Information. ~~The e~~Complete compliance with this policy cannot be overemphasized.

The auditor should maintain an objective attitude, tempered by the fact that we are dealing with human beings. To the extent possible, the auditor should:

- Encourage a cooperative attitude by being cooperative
- Maintain an "arms-length" relationship with the taxpayer in the sense of not becoming personally involved
- Avoid arguing with the taxpayer
- Avoid "humorous" remarks as they are frequently misinterpreted by the taxpayer
- Avoid political and religious discussions

Public relations are a factor during the entire course of the audit. The auditor should develop a sense of timing as to when it is best to discuss the various audit phases with the taxpayer; e.g., after agreement has been reached regarding appropriate test procedures with the taxpayer, no further discussion should be required until test findings are established or necessary changes in agreed procedure are required. On the other hand, many taxpayers prefer to receive schedules of questioned items as they are completed. This makes it possible for the taxpayer to begin work on possible exceptions while the auditor continues the test. This method facilitates a more rapid completion of the audit and makes an early test cutoff possible, if appropriate.

The auditors' appearance, clothing and conduct should be appropriate to their professional status.

There is one basic difference between tax auditing and public accounting: The public accountant is serving their client and is on the client's premises on the request of the client; the ~~tax~~ auditor's presence is usually not requested.

## MONEY LAUNDERING

0401.35

In cooperation with the Department of Justice, the Board has agreed to provide assistance in the enforcement of money laundering violations by reporting suspected violations. If potential violations of money laundering or monetary instrument transaction reporting laws are suspected, a report documenting the suspected violation should be prepared and forwarded to the Chief, Field Operations Division, Equalization Districts 1 and 2 and Out-of-State District or the Chief, ~~Collections and Third District~~ Field Operations Division, Equalization Districts 3 and 4 and Centralized Collection Section. That office will then forward the report to the Department of Justice. This report should be submitted in a form similar to that shown in Exhibit 15.

The law contains two money laundering offenses ~~that staff~~ the auditor should

look for when conducting their regular functions. These are referred to as the "facilitation" offense and the "capturing" offense.

The facilitation offense includes conducting or attempting to conduct a transaction involving a monetary instrument or instruments exceeding \$5,000 through a financial institution with the intent to promote, manage, establish, carry on or facilitate the promotion, management, establishment or carrying on of any criminal activity.

The capturing offense involves the laundering of illegally derived proceeds. It includes conducting or attempting to conduct a transaction involving a monetary instrument or instruments exceeding \$5,000 through a financial institution with knowledge that the monetary instrument represents the proceeds of criminal activity.

Auditors should not spend a significant amount of time investigating potential money laundering violations. However, any suspected violations which are discovered in the course of regular auditing procedures should be reported.

## PROGRAMMING — AUDIT SURVEY

0403.00

### STARTING AN ASSIGNMENT — GENERAL

0403.05

Generally, an assignment should be started only after proper arrangements have been made in advance. In rare instances, it may be desirable to start an assignment without notifying the taxpayer, as in the case of a surprise investigation of a person suspected of fraudulent reporting practices.

If the necessary records are located in an area handled by another district or branch office, the audit assignment normally should be transferred to that district or branch office along with Form BOE-579. This form should be accompanied by a fact sheet setting forth as much pertinent information as is available, including any audit memoranda, that will assist the receiving office in completing the case. The auditor's supervisor may, in unusual circumstances, arrange for the auditor to conduct the audit at the other location.

### PRELIMINARY ARRANGEMENTS

0403.10

~~Certain~~ ~~The following preliminary steps/procedures must be to be taken/performed before starting an audit assignment are:~~

- (a) ~~If available, examine~~ Review the district master file (if available) — to obtain determine information about the taxpayer's type of business, starting date, closeout date, ownership, elose-outs, reorganizations, and general record of reporting; and to review refund notices, delinquencies, audit memos, etc. The following Ttaxpayer information may also be obtained electronically by reviewingthrough the Integrated Revenue Information System (IRIS) or the Internet:
- The IRIS TPS TP screen for prior audit information and petition and claim for refund status. If a "Y" is noted under the appeal category, check the APL PR screen for more information.
  - The IRIS COM BA screen for comments input from all IRIS subsystems. If payment problems are noted, the auditor may request that compliance staff review the account on Automated Compliance Management System (ACMS) for additional information.
  - The Internet to find information on company history, product lines, store locations, recent mergers and acquisitions, etc.
- (b) Contact the taxpayer to arrange for the following information:
- Exact time for starting assignment.
  - Records to be supplied for start of assignment.
  - Name and position of person to be contacted. *(The auditor must leave his or her name and telephone number with the taxpayer at this time.)*
  - Desk space/work area.

(c) Verify registration information, including:

- The current ownership is the same as the permit. Sole proprietors may not know that becoming a partnership or incorporating is a change in ownership.
- The accuracy of the assigned area code(s).
- The accuracy and currency of all subpermits.
- The correctness of the taxpayer's local and transit tax allocation procedures.
- Any other area(s) which could impact the accuracy of the reported local tax.

If any errors are discovered, the auditor is to take *immediate* corrective action, such as including:

- Obtaining the date when the change or error first occurred.
- Notifying District Compliance as described in AM section 0219.03 (or preparing other forms as required by District Compliance) if an area code change is required.
- Notifying District Compliance of new or closed-out subpermits.

The appropriate BOE-80 series "Audit Engagement Letter" should be used to confirm arrangements to begin audits or to establish contact with the taxpayer.

<u>BOE-80-A</u>	<u><i>Audit Engagement Letter – Confirm Start Date</i></u>
<u>BOE-80-B</u>	<u><i>Audit Engagement Letter – Agreement to Delay Start Date</i></u>
<u>BOE-80-C</u>	<u><i>Audit Engagement Letter – Initiate Contact</i></u>
<u>BOE-80-D</u>	<u><i>Audit Engagement Letter – 10-Day Follow Up</i></u>
<u>BOE-80-DOH</u>	<u><i>Audit Engagement Letter – 10-Day Follow Up (Out-of-State)</i></u>
<u>BOE-80-EOH</u>	<u><i>Audit Engagement Letter – In Area (Out-of-State)</i></u>
<u>BOE-80-FOH</u>	<u><i>Audit Engagement Letter – Apology (Out-of-State)</i></u>

Forms BOE-80-A, BOE-80-B, BOE-80-C, and BOE-80-EOH include the following enclosures:

- Form BOE-80-RU, *Record Update*
- Publication 70, *Understanding Your Rights as a California Taxpayer*
- Publication 76, *Audits*
- Publication 17, *Appeals Procedures, Sales and Use Taxes and Special Taxes*

Form BOE-80-RU is intended to help obtain taxpayer's current registration information at the start of an audit. The auditor should verify the accuracy of the information provided by the taxpayer on Form BOE-80-RU and include a comment to that effect on Form BOE-414-Z, *Assignment Contact History*. The original completed Form BOE-80-RU should be included with the audit working papers (AWP). To update the taxpayer's registration information on IRIS, a copy of Form BOE-80-RU should be sent to the District Compliance Supervisor.

Normally the initial contact with the taxpayer will be by telephone. When the audit appointment results from a telephone contact, the appointment must be immediately confirmed by mailing ~~the~~ using Form BOE-80-A, *Audit Engagement Letter - Confirm Start Date*. "Confirm Start Date" letter together with the enclosures listed above. Pamphlet No. 70, "The California Taxpayers' Bill Of Rights," Pamphlet No. 76, "Audits," and Pamphlet No. 17, "Appeals" ~~unless~~ If the audit will commence within a week of making the appointment, ~~the engagement letter and enclosures~~ In that case, the letter and pamphlets may be given to the taxpayer at the start of the audit. If the audit appointment is with the taxpayer's representative, the engagement letter (~~with~~ and enclosures) should be sent to the taxpayer, with a copy to the representative.

The auditor should grant reasonable requests by taxpayers to delay the starting of an audit, but should be alert to detect attempts to forestall it. If an excessive delay in the start date is agreed to, and a reporting period is about to ~~outlaw~~ expire, the Form BOE-80-B, *Audit Engagement Letter - Agreement to Delay Start Date* "Agreement to Delay Start Date" should be used, enclosing a Form BOE-122, "Waiver of Limitation," (BOE-122) covering a minimum of two calendar quarterly reporting periods ~~quarters~~ should be included in the enclosures. (AM section 0215.15 provides guidance when a waiver of limitation should be requested). If the audit is a result of a claim for refund filed by the taxpayer, a Form BOE-146, *Waiver of Credit Interest*, should be obtained.

If the auditor is unable to contact the taxpayer by telephone, ~~the~~ Form BOE-80-C, "Initiate Contact" letter *Audit Engagement Letter - Initiate Contact* should be used, and if the taxpayer does not respond by the date specified on Form BOE-80-C, necessary followed up with the Form BOE-80-D, "10-day follow-up" letter *Audit Engagement Letter - 10-Day Follow Up* should be sent to the taxpayer. ~~The BOE-80-D letter~~ As Form BOE-80-D states explains, that if the books and records are not provided by a specific date, "we the Board will either be required to issue a subpoena requiring that you the taxpayer to provide the books and records or prepare a billing for estimated additional taxes due." Also, ~~†~~ The books and records must be subpoenaed when an estimated billing has been prepared and the taxpayer, at any time, disagrees with the proposed assessment or determination.

During the course of an audit, if the taxpayer or the taxpayer's representative refuses to provide or claims not to have some or all of the records which the auditor has requested orally, the auditor, after consulting with his or her supervisor, must decide on the course of action to pursue. When computerized records are maintained, taxpayers will be required to make them available according to the requirements of Regulation 1698, *Records*. The following procedures, as well as the procedures discussed in AM section 1304.35, *Methods of Selecting A Sample*, should be followed when it has been determined that computerized records exist ~~that could~~ and can be used for testing purposes to which the taxpayer refuses to provide access. The following procedures should

also be used when non-computerized ("paper") records are maintained.

- If most of the records are available, or the auditor believes that the requested records do not exist and the estimated deficiency is either small or would not be significantly altered if the records were available, then no further effort should be expended to obtain the records. A letter should be written to the taxpayer confirming that a request for the records had been made, acknowledging that the taxpayer or representatives failed to provide the records requested, and advising that a billing based on an estimate is being prepared.
- If records sufficient to complete the audit have not been provided and/or the auditor believes records exist that would materially change the results of the audit, the auditor must notify his/her supervisor. The supervisor will prepare a written request to the taxpayer for specific records necessary to perform the audit and explain the relevance of the records requested. Any previous oral requests should be referenced in the letter. The letter must specify a date by which the records are to be furnished. A copy of the letter will be enclosed as a memo schedule in the audit.
- If the taxpayer does not comply, the District Principal Auditor must send a follow up letter to the taxpayer referencing the supervisor's letter. The letter should advise the taxpayer of the requirements of R&TCRTC sections 7053, (*Records*), and 7054, (*Examination of Records*), and inform them that a subpoena will be issued for the records and/or a billing prepared for estimated additional taxes due, unless the requested records are provided within a specified period (usually 10 days). If the taxpayer does not provide the records, the action to subpoena the records should commence. If a waiver of limitations cannot be obtained and outlawing periods have significant tax deficiencies, an estimated billing should also be prepared.

~~All Comments regarding contacts and attempts to contact taxpayers, both oral and written, must be documented on the Assignment Contact History, Form BOE-414-Z, Assignment Contact History. Copies of correspondence referenced on the Form BOE-414-Z should be filed included as a memo schedule ~~in~~ with the audit working papers AWPs. It should be clear ~~from~~ noted in the "books and records" comment ~~on the back~~ of the Field Audit Report or ~~FBO~~ Field Billing Order if any records were withheld or were not available. *The working paper auditor's comments must clearly reflect state the effect the any lack of records ~~has had~~ on the amount determined billed.*~~

## **DISCUSSION WITH TAXPAYER**

**0403.12**

When the auditor arrives at the taxpayer's place of business at the appointed time, the auditor should have a preliminary discussion with the taxpayer or with the person who has charge of the records before starting the audit work. A representative tax return should be examined, and the taxpayer should be

requested to point out the source of the figures used to compile the return. **A discussion about how the ledgers and summary records are maintained is imperative at this time.**

The auditor should determine, by direct questioning of the taxpayer, the exact nature of the business activity for the audit period. Inquiry should be made about changes in key clerks, accountants and/or accounting systems, as variations in the type of business, or in the methods of conducting business will have an effect on the approach to making an audit.

#### **CONTACTS WITH THIRD PARTY REPRESENTATIVES**

**0403.14**

In order to protect the taxpayer, it is imperative that before any discussion or correspondence is initiated with a person claiming to be a representative of the taxpayer, the auditor secures written authorization from the taxpayer. It is not generally necessary to obtain this authorization when the taxpayer introduces or refers the auditor to their representative. It is also not necessary to obtain an authorization when the representative is a professional governed by a code of ethics, e.g., a certified public accountant or attorney. However, it is a good practice when contacted unilaterally by a professional to acknowledge the contact in writing with a copy to the taxpayer. Taxpayers should receive copies of all correspondence between the Board and ~~their~~ taxpayer's representative concerning their taxpayer's case(s).

#### **LIMITATIONS ON CONTACTS WITH TAXPAYERS REPRESENTED BY COUNSEL**

**0403.16**

Board employees who are not attorneys are not required to refrain from contacting or speaking with taxpayers who are represented by legal counsel, a CPA, or other representatives, even in those instances where the representative has requested that the employees do refrain. Thus, an auditor may disregard a representative's request to continue to contact the taxpayer but should be done only after consulting with the employee's his or her supervisor. Such action should and be based, in part, on the representative's degree of cooperation with Board staff the auditor and the fact that the taxpayer does not timely comply with the Board action requested through the representative.

If the taxpayer or ~~his or her~~ the taxpayer's representative has requested that no contact with the taxpayer be made without the taxpayer's representative present, the auditor should notify his or her direct supervisor and fully document the request on Form BOE-414-Z, Assignment Contact History. In addition, all subsequent contacts with the taxpayer should be documented on ~~the~~ Form BOE-414-Z to protect against potential claims or allegations of harassment. A supervisor or lead person may also accompany the employee for difficult negotiations.

If the taxpayer or his or her attorney has obtained a restraining order forbidding contact by the Board without the attorney present, the Board employee must comply with the order. In such cases, the Chief, Field Operations Division,

Equalization Districts 1 and 2 and Out-of-State District, or the Chief, Collections and Third District Field Operations Division, Equalization Districts 3 and 4 and Centralized Collection Section, Internal Security and Audit Division, and the Chief Counsel should be notified of the order for appropriate action.

**WRITTEN CORRESPONDENCE**

**0403.18**

The ~~staff~~ auditor should confirm in writing any significant verbal contact or agreements with the taxpayer or ~~their~~ taxpayer's representative which involve:

- Delays in appointments
- Records that are not available
- Requests for supporting documentation
- Requests for books and records
- Requests for delay of audit work
- Confirmation of meetings to discuss audit findings
- Other contacts significant to the audit

By use of this procedure, the taxpayer will be kept aware of the progress of the audit. When corresponding directly with the taxpayer's representative, a copy should always be sent to the taxpayer.

## USE OF PRIOR AUDIT PERCENTAGES OF ERROR IN CURRENT AUDITS

0405.33

This program will involve the use, under certain circumstances, of a percentage of error developed from ~~in a~~ prior audits for the sales or accounts payable portion of a current audit. The techniques used in the prior audits to calculate the percentages of error will not preclude the use of the prior audit percentage; however, other factors, as noted below, must be taken into consideration before approving the use of the prior audit percentage in a current audit.

Each district office will identify taxpayers currently under audit or selected for audit with at least ~~two~~ one prior audits, ~~where~~ the last ~~most~~ recent ~~two~~ prior audits and the current audit must indicate a relatively consistent percentage of error ~~operations, volume, and potential type of errors~~. Once these taxpayers have been identified, limited testing of the taxpayer's records and internal controls will be necessary in order to determine whether there have been any changes to the taxpayer's operations since the last audit. Such testing should include an examination of source documents, such as invoices and paid bills, for changes in processing procedures of such since the last audit. Other changes to look for include:

1. The nature of their business
2. Their accounting procedures
3. Key personnel
4. Laws or regulations affecting their business
5. Significant increases in the population being sampled

If stratified dollar limitations were used in the last ~~two~~ audits, generally the same dollar stratification should be used in the current audit. However, if there is an indication during the limited testing that a different stratification level may be appropriate in the current audit, the new stratification level should be used. If so, the prior percentages of error will have to be adjusted to reflect the new stratification level.

For example, a decrease or increase in the stratification level will affect the sample base (by deleting or including sample items), the population base (by deleting or including population items) and the percentage of error (by deleting or including error items) in the prior audits. These recalculations must be made so that the proposed percentage of error to be used in the current audit is an accurate representation of the prior audit percentages of error at the new stratification level.

This information should then be used by the District Principal Auditor and audit supervisor to evaluate such taxpayers for inclusion in this program.

Those taxpayers meeting the criteria described above should then be contacted and informed of the program ~~explained to them~~ by an auditor and audit supervisor. The taxpayer must also be informed that this procedure will not be used in consecutive audits.

After the discussion with eligible taxpayers, a detailed outline memo from the Audit Supervisor to the District Principal Auditor (Exhibit 6, page 1) should be prepared for each interested taxpayer indicating why they would make a good candidate for inclusion in this program. Each outline should include:

- (a) Name and account number of the eligible taxpayer
- (b) Nature of taxpayer's business
- (c) Current audit period
- (d) Portion(s) of audit where a prior percentage of error is to be used
- (e) Prior audit periods and corresponding percentages of error for those portion(s)
- (f) Population(s) to which the prior percentage(s) of error was applied
- (g) Proposed percentage of error to be used for the portion(s) in the current audit
- (h) Population(s) to which the proposed percentage(s) of error will be applied in the current audit
- (i) Any other pertinent information

~~This~~ ~~The memo outline should then be sent~~ ~~approved by the District Principal Auditor and maintained in the audit as a memo schedule.~~ ~~to the Chief, Tax Policy Division (with a "cc" to the Chief, Field Operations Division or the Chief, Collections and Third District Operations Division) for review and evaluation (Exhibit 6, page 1).~~ ~~The district will be notified of the decision regarding the review and evaluation.~~ Upon completion of the audit, the district will prepare an evaluation memo (Exhibit 6, page 2) to the Chief, Tax Policy Division with a copy to the Chief, Field Operations Division, Equalization Districts 1 and 2 and Out-of-State District, or the Chief, Field Operations Division, Equalization Districts 3 and 4 and Centralized Collection Section.

~~(with a "cc" to the Chief, Field Operations Division or the Chief, Collections and Third District Operations Division).~~ The evaluation memo must include detailing the tax change of the at portion(s) of the audit utilizing the prior percentage of error along with an estimate of the number of audit hours saved. A copy of the evaluation outline memo and authorization memos should be included as memo schedules in the audit working papers attached to the evaluation memo.

## **CUT-OFF TECHNIQUES**

**0405.35**

"Cut-Off" is that point in the audit program where the auditor has accumulated sufficient data to support a reasonable conclusion or opinion based on acceptable audit standards. It might be defined as when to stop testing or examining data. This may refer to the audit as a whole or to a specific task or test. This is a judgment area for the auditor. For example, when a short test indicates an error, but an expanded test does not seem to sustain this error, the auditor must stop and analyze why this condition exists, whether to continue testing and on

what basis, etc.

When a prospective cut-off point is reached, a decision should be made whether to accept the test results, alter the audit approach, or discontinue the audit. In terms of testing, the audit approach or testing program may be altered by:

- (a) Expanding the test base by inclusion of additional test periods.
- (b) Narrowing the test base because the results do not disclose significant error. For example:
  - Cut-off detail examination of certain invoices to examine only those over a given amount.
  - Cut-off detail examination of certain invoices to examine only those for certain customers or vendors as the case might be.

Important points to consider in deciding whether to cut-off, alter the audit approach, or discontinue completely are:

- (a) Materiality of error encountered.
- (b) Frequency of error.
- (c) Blind alleys:
  - Source detail missing.
  - Change in filing system.
- (d) Discovery of a more efficient approach, e.g., change from invoice testing to an accounts payable examination selection of certain vendors. This will be found to be equally applicable to sales invoices and accounts receivable.
- (e) Arrival at an opinion prior to completion of the test as originally planned.

## ASSERTION OF USE TAX ON LEASES

0408.17

In general, use tax will only be asserted against the lessor since it is difficult to determine from the lessee's records whether the lease is a "sale" under the Sales and Use Tax Law. Therefore, a review of the lessor's records is necessary to determine if any tax liability exists. In addition, such a procedure insures that lessors are properly permitized and reporting the tax. Whenever the audit of a lessee reveals that tax has not been collected by the lessor, and the auditor cannot determine that tax was properly due, an audit memorandum (Form BOE-1164 or Form BOE-1032) should be prepared and sent to the lessor's district. The auditor should not assert tax against the lessee.

An exception to the above general policy is that tax may be assessed against the lessee if the lessor is located out-of-state and does not have a California seller's permit, and the property being leased is **not** mobile transportation equipment (MTE). If tax is assessed, a Form BOE-1164 or Form BOE-1032 should be sent to the lessor's district showing the amount of tax assessed and the applicable periods.

As a note, the California Sales and Use Tax Law does not provide an exemption from sales or use tax for sales made to California governmental agencies. This provision also applies to out-of-state sellers and lessors who make sales or leases to California governmental agencies. In such case, the registered out-of-state retailer should collect and report the California use tax.

### USE OF FORM BOE-1164, AUDIT MEMORANDUM ON SELLER OF POSSIBLE TAX LIABILITY

0408.20

In making an the examination of purchase invoices, it the auditor frequently notices will be noticed that the California vendor has did not charged sales tax on some or all of the invoices issued, and the purchaser has did not issued a purchase order marked "for resale" and or a resale certificate has not been issued to the vendor. The nature of the merchandise will sometimes be sufficient evidence to indicate that a resale certificate, if timely given, was not taken in good faith; e.g., where a retail jewelry store purchased janitorial supplies or a service station purchases a commercial type hydraulic jack. If in doubt, and the amount involved is substantial, the auditor may contact the vendor to determine whether the vendor holds a valid resale certificate. In the event the vendor does not have a valid resale certificate, the tax should not be determined against the purchaser unless the sale occurred outside of California or is otherwise a transaction subject to use tax. Rather, a Form BOE-1164 should be prepared, in duplicate, setting forth the pertinent facts about the transaction. This form, along with any supporting documents, will be used as basis for investigation.

The auditor should also prepare Form BOE-1164 if in the examination of sales invoices, the auditor finds that the seller did not charge tax and has accepted a properly executed resale or exemption certificate in good faith and the auditor questions whether the buyer has in fact purchased the merchandise for resale or

in fact an exemption applies. The auditor should mark the block "Seller has valid (resale) (exemption) certificate from buyer on file." The auditor must also attach a photocopy of that certificate to the Form BOE-1164.

~~The original will be used as a basis for investigating the vendor. The duplicate will remain with the working papers. (See section 0401.20, including Confidentiality of Information.) The auditor also should also use a prepare Form BOE-1164 where it is determined that a vendor is improperly computing tax on its invoices. For example:~~

- May not be charging tax.
- Charges tax on repair labor or other exempt items.
- Does not charge tax on fabrication labor, trade-ins, or other components of the sale which should be included in the measure of the tax.
- Unsupported sales for resale to Mexican merchants which are discovered during audits of California sellers should be disallowed against the seller (see ~~Publication 32, Tax Tips for Sales to Purchasers From Mexico~~ for an explanation of the Mexican merchant program). However, the auditor should prepare a Form BOE-1164, identifying the purchaser and describing the merchandise purchased, should be prepared for such sales. The forms should identify the purchaser and describe the merchandise purchased. The completed form should be sent to the San Diego District Office for its information in monitoring and administering the Mexican merchant program and taking possible action against any merchants who abuse the program (AM section 0409.50).

See AM section 0401.20 for information on confidentiality of Form BOE-1164, and AM section 0213.03 for distribution of this form.

### **USE OF AUDIT MEMO FORM BOE-1032, INFORMATION ON OUT-OF-STATE RETAILERS**

**0408.22**

Out-of-state retailers "engaged in business in this State" are required to register and collect use tax on taxable sales made to consumers in this State. A firm-retailer is engaged in business in this State if it has any representative, agent, sales person, canvasser, independent contractor or solicitor operating in this state, either under ~~its~~ the authority of the retailer or that of a subsidiary, for the purpose of selling, delivering, installing, assembling or ~~the~~ taking of orders for any tangible personal property in California.

Auditors should be alert to recognizing and reporting interstate retail sales by persons who are not collecting the tax. When an auditor discovers that a taxpayer is making ~~untaxed~~ taxable purchases subject to use tax from an unregistered out-of-state vendor without tax, the auditor should advise Out-of-State District Compliance of the vendor, using a Form BOE-1032 (Exhibit 3), "Information on Out-of-State Retailers." If the vendor is registered, the proper form to use is Form BOE-1164 and not Form BOE-1032.

~~This form Form BOE-1032 assists helpful Out-of-State Compliance staff in the properly registering registration of out-of-state vendors who are engaged in business in California. The BOE 1032's should be forwarded when they are originated and not held until the audit is complete. A **separate Form BOE-1032 must be prepared for each vendor.** It is incorrect to attach a schedule for all vendors to one Form BOE-1032. The purchaser's and out-of-state retailer's information must be completed on all Form BOE-1032s along with all other information. However, copies of invoices and a schedule listing all invoices can be attached to a Form BOE-1032 for each vendor instead of preparing multiple Form BOE-1032s for each vendor's invoice. It is emphasized that a copy of the invoice and schedule of purchases may not serve as a substitute for completing the actual Form BOE-1032 (except for invoice date, number, and item description, and amount of use tax reported or included in audit). *Additionally, it is stressed that a copy of the invoice **and** copy of the paid bill schedule is the best information to attach to the Form BOE-1032.* Auditors must ~~be~~ make sure the complete address, including the zip code, is noted on Form BOE-1032 (~~a separate space for the zip code will be added in the future to this form~~). Without a complete mailing address, it is extremely time consuming and often impossible for Out-of-State District Compliance to properly identify the vendor for correspondence regarding possible registration. ~~A copy of the BOE 1032s prepared in an audit should be retained in the audit as a memo schedule.~~~~

Analysis of purchases from out-of-state retailers may develop information that will lead not only to the registration of out-of-state firms/businesses, but to the possibility of additional tax liability on the part of those who are registered. Attention should be given to volume purchases of small items as well as to purchases of large items. (Sales made by sellers in contiguous states deserve special ~~more~~ attention since their volume of business in California ~~is often~~ is generally extensive.) Reports on sales made to firms/businesses in the food processing, entertainment, and service fields/industries merit special attention since these types of business may not be required to hold a seller's permit and use tax due from such businesses ~~ordinarily would~~ may not come to the Board's attention.

~~Information required to effect registration should be completed on Form BOE-1032, Information on Out-of-State Retailers. (See section 0401.20, including Confidentiality of Information).~~ Information required on Form BOE-1032 includes:

- a. Name and address of out-of-state retailer.
- b. Name and address of sales representative.
- c. Name and address of customer.
- d. Invoice number.
- e. Date of invoice.
- f. Amount of invoice.

- g. Description of property sold.
- h. How sale was solicited.
- i. Any other relevant information concerning seller, sales representative, scope of sales, etc.

In completing Form BOE-1032, the importance of items (a), (b), (h) and (i) cannot be over emphasized. This information should be obtained, if at all possible, in order to enable Out-of-State District Compliance to determine whether an out-of-state retailer should, in fact, be registered despite a contention made that it ~~was~~ is not "engaged in business" in the state.

See AM section 0401.20 additional information including confidentiality of Form BOE-1032, and AM section 0213.03 for distribution of this form.

### **CALIFORNIA USE TAX COLLECTIONS BY UNREGISTERED OUT-OF-STATE RETAILERS**

**0408.23**

During audits of California taxpayers, it has occasionally been noted that California use tax is being remitted to out-of-state vendors who are not billing the purchasers for the use tax.

Auditors should be alert to these types of transactions and, by utilizing ~~the~~ IRIS, determine whether such out-of-state retailers are registered. When an auditor discovers that a taxpayer is erroneously paying use tax to an unregistered out-of-state vendor, the auditor should immediately advise Out-of-State District Compliance. Additionally, the purchaser should be informed of ~~their~~ the responsibility for the payment of ~~the~~ tax to the proper authority per Regulation 1685, Payment of Tax by Purchasers. ~~Also, each~~ Retailers who are required to collect use tax from purchasers must give a receipt to each purchaser (or lessee) for the amount of tax collected. ~~Please refer to~~ Regulation 1686, Receipts for Tax Paid to Retailers, ~~for the information~~ lists information required ~~to be shown~~ on the receipt.

## AUDITING PROCEDURE

0410.10

An audit of this deduction should be made in the same manner as an audit of a deduction for sales for resale. Ordinarily the number of such sales is limited and the audit should be made on a complete basis. If, however, the number of items claimed is exceptionally large and the average unit of sale is comparatively small, a test basis may be used. Documentary evidence required to support the deduction, where the sale is made directly to the United States Government, a subdivision or agent, should consist of one or more of the following documents:

- Purchase orders
- Copy of U.S. Government credit card or credit card number
- Other documents demonstrating direct payment by the United States
- Shipping and other documents if there is a question whether the merchandise was sold directly to an individual who is in the armed services

In the absence of documentation to support claimed sales to the U.S. Government, the auditor may determine that it is appropriate for a seller to use the Form BOE-504 series of forms (BOE-504-CUS) procedure to help satisfy their burden of proving that a sale was not at retail even though exempt documentation was not obtained (see AM section 0409.51 for procedures).

Sales to contractors who are engaged in work on projects owned by the United States Government are not sales to the Government. If the contractor is actually selling tangible personal property to the U.S. Government, such sales are sales for resale and should be verified as such. Mention is made of this in this AM section only because many retailers classify such sales as sales to the United States Government and erroneously claim the deduction under that heading rather than sales for resale. If the auditor has reason to believe the material purchased was not actually sold by the contractor-customer to the U.S. Government, a Form BOE-1164, ~~Audit Memorandum of Possible Tax Liability~~ (see AM section 0401.20), should be prepared setting forth all pertinent phases of the transaction.

## SALES TO FEDERAL EMPLOYEES USING U.S. GOVERNMENT BANKCARDS 0410.15

The federal government issues credit cards to its employees for purchases of goods and services. ~~Beginning November 30, 1998, the purchases are under a the current new program called "GSA SmartPay," and is effective through November 28, 2008. Credit Cards will now be under this program~~ are issued by Citibank, ~~First National Bank of Chicago~~, JPMorgan Chase, ~~NationsBank~~, Mellon Bank, Bank of America, and U.S. Bank. The current contract with these banks is set to expire on November 29, 2008 and will be replaced by a new program called "GSA SmartPay2" which will run from November 30, 2008 to November 29, 2018. Citibank, JP Morgan Chase, and U.S. Bank will continue to issue credit cards and debit cards under the GSA SmartPay2 program.

The ~~new~~ credit and debit cards bear 16-digit account numbers with unique prefixes, and government designed artwork, and are imprinted with "United States of America" at the top. In the right-hand corner, cards contain a logo which says "SmartPay." The cards also bear wording that denotes the card is for "Official Government Use Only." The General Services Administration (GSA) administers the program for all departments and agencies of the U.S. Government.

Purchases made with most ~~of the new~~ cards are directly billed to the government and will represent nontaxable sales to the U.S. Government. Those purchases directly billed to the employee are subject to sales tax. To determine which government credit cards are government-billed and which are employee-billed, retailers will have to consider the type of card, the type of transaction, and the card account numbers. Generally, through use of the Bankcard System and coding authorization, purchases are automatically denied if a particular type of card is used to make a type of purchase for which that card was not issued.

For **FLEET CARDS**, there are two types of U.S. Government "fleet" cards which may be issued to federal employees to make fleet type purchases (e.g., gasoline, oil, etc.). One is a Voyager card and the other is a MasterCard. The Voyager cards contain 16-digit account numbers that starts with the prefix 8699. The MasterCard cards contain 16-digit account numbers that start with the prefixes 5565 and 5568. All fleet type purchases made with these cards are billed directly to the U.S. Government and are not taxable.

For **PURCHASE CARDS**, there are two types of U.S. Government "purchase" cards which may be issued to federal employees to make purchases of goods (e.g., office supplies, parts, etc.). One is a credit or debit VisaISA card and the other is a credit or debit MasterCard. The Visa cards contain 16-digit account numbers that start with the prefixes 4486, 4614, or 4716. The MasterCard cards contain 16-digit account numbers that start with the prefixes 5564, 5565 or 5568. All purchases of goods made with these cards are billed directly to the U.S. Government and are not taxable.

For **TRAVEL CARDS**, there are two types of U.S. Government "travel" credit cards which may be used by federal employees to make travel type purchases (e.g., hotels, car rentals, restaurants, etc.). One is a VisaISA card and the other is a MasterCard. The Visa cards contain 16-digit account numbers that start with the prefixes 4486 or 47164614. The MasterCard cards contain 16-digit account numbers that start with the prefixes 5565 or 5568. Federal government travel cards may either be billed to the U.S. Government or to the federal employee depending upon the account number. If purchases made with travel cards are billed to the employee, the sales are subject to tax. To determine whether purchases made with federal government travel cards are government-billed or employee-billed, retailers must look at the 6th digit of the account number of the card. If the 6th digit is 1, 2, 3, or 4, purchases are billed to the employee and are taxable. If the 6th digit is 0, 6, 7, 8, or 9, purchases are billed to the U.S. Government and are not taxable. This procedure applies to both VisaISA and MasterCard travel cards.

In some instances, some federal agencies will issue **INTEGRATED CARDS** for the purpose of "fleet," "property," and "travel" purchases. These cards are provided by MasterCard and contain a 16-digit account numbers with prefixes that starts with 5564, 5565 or 5568. All fleet and property purchases made with these cards are billed directly to the U.S. Government and are not taxable. However, travel purchases may be either government-billed or employee-billed depending upon the account number. To determine whether travel purchases are government-billed or employee-billed, retailers must again look at the 6th digit of the account number of the card. If the 6th digit is 1, 2, 3, or 4, purchases are billed to the employee and are taxable. If the 6th digit is 0, 6, 7, 8, or 9, purchases are billed to the U.S. Government and are not taxable.

*Exception: All purchases made with integrated MasterCard credit cards provided by the Bureau of Reclamation employees, including travel purchases, are billed directly to the U.S. Government and are thus exempt from tax. Bureau of Reclamation employees will have to identify themselves to the retailer and show proof of Bureau employment to obtain the exemption.*

Retailers who make U.S. Government credit card sales should retain the credit card receipt containing the imprint of the credit card and the sales invoice to support exempt transactions to the U.S. Government. If the purchase is by telephone, the retailer should note the credit card account number and purchaser's name on the credit card receipt.

## LEASES

0411.25

In general, a lease of tangible personal property to a United States contractor is subject to tax whether or not such contractor is properly authorized to act as a purchasing agent of the United States. However, leases are exempt when they are (1) to contractors that occupy the legal status of agents of the United States and (2) to non-agent cost-plus federal contractors, other than Department of Defense contractors, that act as agents when procuring from General Services Administration ("GSA") Supply Sources ("FSS" or "ADPS") pursuant to a letter of authorization issued by a federal contracting officer which has language creating an agency relationship.

It has been the policy of the Department of Defense not to designate government contractors as legal agents of the United States. Therefore, a lease between a Department of Defense contractor and a vendor would not include the United States as a party to such lease, notwithstanding any FAR provision which attempts to characterize the buyer-lessee as an agent for the Department of Defense. Consequently, lease payments made by a Department of Defense contractor, which are charged as direct consumable supplies to a fixed price contract or cost reimbursement contract are subject to the sales or use tax.

Should a Department of Defense contractor nevertheless claim agency relationship with respect to a lease, the contractor should be requested to provide documentation to support such claim. The documentation should be submitted to the Chief, Tax Policy Division (with a "cc" copy to the Chief, Field Operations Division, Equalization Districts 1 and 2 and Out-of-State District or the Chief, Collections and Third District Field Operations Division, Equalization Districts 3 and 4 and Centralized Collection Section for communication with the Secretary of Defense to ascertain the Department's position with respect to the specific contract.

## BAD DEBTS INCURRED BY LENDERS ON PURCHASED ACCOUNTS RECEIVABLE

0419.17

### General

A retailer may sell an account receivable ("account") ~~may be sold~~ with or without recourse. "With recourse" means the retailer must reimburse the purchaser of the account ("lender") for any losses the lender suffers. "Without recourse" means the retailer has no obligation to reimburse the lender even if the lender cannot recover the full amount of the debt.

**Accounts sold with recourse:** A lender who purchases an account with recourse may not take a bad debt deduction under the Sales and Use Tax Law with respect to any loss it suffers on that account (i.e., uncollectible debt for which it fails to obtain reimbursement from the retailer). However, a retailer who sells an account with recourse may take a bad debt deduction for the amount of uncollectible debt for which the retailer actually reimburses the lender pursuant to their contract, to the extent that such loss represents amounts on which the retailer reported and paid tax. These rules remain the law, and have not been affected by the provisions of Regulation 1642(h)(3) and (i).

**Accounts sold without recourse:** Regulation 1642(h)(3) and (i) apply to bad debt losses incurred on accounts created as a result of retail sales of tangible personal property for which the retailer remitted California sales or use tax on or after January 1, 2000. Transactions prior to January 1, 2000, may qualify for treatment under the Board's memorandum opinion in WFS Financial, Inc. (WFS) as discussed below.

### Regulation 1642 subdivisions (h)(3) and (i)

Auditors reviewing lenders' claims for deduction or refund for which the retailer remitted California sales or use tax on or after January 1, 2000 should review Regulation 1642(h)(3) and (i). The subdivisions describe the conditions that must be met to claim a deduction or refund, the election agreement between the retailer and the lender, and election agreements between lenders and affiliated entities.

*Due to reporting requirements of 1642(h)(3) and (i), it is theoretically possible to have an annual basis retailer sell account receivables to a lender, which would make 1642(h)(3) and (i) apply to sales made for the entire year of 1999.*

### WFS Memorandum Opinion

On December 14, 2000, the Board issued a memorandum opinion on a claim by a financial institution, WFS, for a refund for bad debts incurred from accounts purchased without recourse. The WFS Financial, Inc. opinion sets forth the requirements of when such transactions can qualify for bad debt deductions. The opinion can be found in the memorandum opinion section of the Business

## Taxes Law Guide.

The Legislature's adoption of AB 599 (Stats. 2000, Ch. 600) ~~supereeded~~superseded and replaced the WFS Financial, Inc.—memorandum opinion. Revenue and Taxation Code ~~RTC~~ sections 6055 and 6203.5, as amended by AB 599, are incorporated into and explained in Regulation 1642, *Bad Debts*. The WFS decision applies through December 31, 1999, but not thereafter. †The provisions of Regulation 1642(h)(3) and (i) became operative on January 1, 2000. Regulation 1642 (h)(3) and (i) generally apply to bad debts incurred in connection with transactions occurring during the 4th quarter 1999 since the taxes on those transactions were generally paid after January 1, 2000. However, the WFS decision itself applied to a claim for refund that included the 4th quarter 1999. Accordingly, to ensure fair and uniform treatment of all lenders and for administrative ease, a lender may rely on the provisions of either WFS **or** Regulation 1642(h)(3) and (i) for bad debts incurred in connection with transactions that occurred during the 4th quarter 1999. The provisions of WFS and Regulation 1642(h)(3) and (i) are otherwise mutually exclusive.

It is imperative to note that the determination of whether WFS or Regulation 1642(h)(3) and (i) applies is based on the date the taxes were remitted (usually ascertained based on the date at which the sale occurred), not the date the bad debts were incurred. For bad debts incurred in connection with sales of tangible personal property during the 3<sup>rd</sup> quarter 1999 and earlier, only the provisions of WFS apply and **not** the provisions of Regulation 1642(h)(3) and (i). Generally for bad debts incurred in connection with sales of tangible personal property during the 1st quarter 2000 and later, only the provisions of Regulation 1642(h)(3) and (i) apply and **not** the provisions of WFS. ‡

Since the determination of whether WFS or Regulation 1642(h)(3) and (i) applies is based on the date tax was paid, but the timing of the bad debt deduction is based on the date the loss is written off, there will be claims submitted which include losses covered by both WFS and Regulation 1642(h)(3) and (i) which were written off in the same reporting period. For example, in the 2nd quarter 2002, a lender writes off two accounts as worthless, one for a sale that occurred in the 1st quarter 1999 and the other for a sale that occurred in the 1st quarter 2000. Tax had been paid for the first transaction prior to January 1, 2000, and the provisions of WFS apply to the loss from that account. Tax had been paid for the second transaction after January 1, 2000; therefore, provisions of Regulation 1642(h)(3) and (i) apply to that loss. Since the lender's right to claim the losses from these two accounts was established during the 2nd quarter of 2002, the deduction for both accounts should be taken on the lender's return for that reporting period. This means the statute of limitations for filing the lender's claim related to the losses on both accounts starts to run on July 31, 2002 (the due date of the return for the 2nd quarter 2002).

## **Indirect Loans**

If a consumer wishes to make a purchase on credit without using an existing credit account, the consumer may apply for a loan for that particular purchase. This is the method used for most purchases of automobiles, aircraft, and vessels, as well as many other large purchases, such as jewelry. The retailer may coordinate the loan application process, with the consumer signing a credit contract with the retailer who thereafter assigns the account to a lender. This type of loan is commonly called an “indirect loan” because the consumer does not contract directly with the lender who will service the loan, but rather contracts with the retailer. Since the retailer will then assign the account to the lender, bad debts from these accounts may qualify for deduction under Regulation 1642(h)(3) and (i).

## **Direct Loans**

Alternately, a consumer may arrange his or her own financing by contracting for a loan directly with a lender. This type of loan is commonly called a “direct loan” because the consumer contracts directly with the lender who will service the loan. In a direct loan situation, the consumer pays for his or her purchase with the proceeds from the loan (plus any down payment or other amounts paid out of the consumer’s own funds). Methods of remitting the loan proceeds to the retailer include:

- a check issued by the lender in the retailer’s name, which may be sent directly to the retailer or physically delivered by the consumer;
- a check issued in the names of both the retailer and the consumer which must be executed by both parties (and which may also be sent directly to the retailer or be physically delivered by the consumer, although the latter is more common because the consumer must also execute the check);
- and a direct electronic funds transfer from the lender to the account of the retailer.

The Board held in a separate case that bad debts incurred on certain direct loans are also eligible for deduction under WFS guidelines. In that case, although the purchaser contracted for financing directly with the lender, the lender worked closely with the dealer and remitted payment directly to the dealer. If instead the loan proceeds were to come into the full possession of the consumer (e.g., the consumer deposits the funds into the consumer’s own account and then draws from that account to pay the purchase price), the loan would not qualify under WFS. Furthermore, for a direct loan to qualify under WFS, the dealer must receive payment in a manner that is essentially the same as for indirect loans that qualify under WFS. While no specific time frame is required, this usually occurs within ten days of the date of sale. For example, when the loan is for the purchase of a vehicle, a qualifying direct loan would result in the lender’s name

being placed as lien holder on the ownership certificate as part of the initial registration of the vehicle in the consumer's name. Of course, the other conditions specified in WFS must also be satisfied.

The Board's decision that a lender making a direct loan might qualify for a bad debt deduction under WFS is also applicable to claims for bad debt deductions or refunds under Regulation 1642(h)(3) and (i). However, no deduction or refund is allowable unless and until the lender and the retailer who paid the tax file the election as explained in Regulation 1642(h)(3) and (i). Furthermore, Regulation 1642(h)(3) and (i) applies only when the lender has purchased the account directly from the retailer, or when the lender holds the account pursuant to the lender's contract directly with the retailer. Thus, even if a lender providing a direct loan can convince the retailer to sign an election agreement with the retailer, that does not automatically mean that the losses on the account will qualify for deduction or refund under Regulation 1642(h)(3) and (i). For Regulation 1642(h)(3) and (i) requirements with respect to a direct loan, a lender claiming a bad debt deduction or refund will be regarded as satisfying these conditions if the transaction would have qualified for deduction under WFS (as modified by the Board's ruling on direct loans).

For example, a consumer obtains a line of credit with a lender, perhaps secured by a second deed of trust on the consumer's home. The consumer then uses a check to access the line of credit to purchase a big-ticket item. The retailer receiving the check has no contact whatsoever with the lender except to deposit the check and obtain the funds. The lender and retailer thereafter enter into an election agreement. The loss on this account cannot qualify for deduction or refund under Regulation 1642(h)(3) and (i) since the lender cannot be regarded as having purchased the account from the retailer or holding the account pursuant to a contract with the retailer. On the other hand, a consumer applies for a loan from his or her credit union to purchase a vehicle. The consumer then purchases a vehicle under the normal vehicle sales contract giving him or her a stated number of days to pay the purchase price to the dealer. If the consumer does not make payment timely, the sales contract provides for the dealer to carry the loan (which the dealer could promptly assign to a lender, perhaps even the consumer's own credit union). During the completion of the paperwork and during the sale transaction process, the consumer provides information to the dealer regarding the credit union loan. The dealer contacts the credit union directly and after the necessary paperwork is completed, the credit union deposits the funds directly into the dealer's account. This direct loan will be regarded as satisfying the requirements that the lender purchased the account from the dealer, and if the other requirements of Regulation 1642(h)(3) and (i) are satisfied, the lender is eligible to claim a bad debt deduction or refund under Regulation 1642(h)(3) and (i).

## **Refinanced Loans**

When a loan is refinanced with the original lender, there are two situations where a deduction for bad debts incurred on the refinanced loan will be allowed provided all other requirements for a deduction are satisfied. One is when the refinancing is for the purpose of lowering the amount of the payment (through a reduced rate or extension of the term). The other is when the purpose of the refinancing is to obtain additional funds to pay for necessary repairs to the property purchased with the funds from the original loan, but only when the lender makes payment directly to the repair facility. When calculating the amount of the bad debt loss on qualified refinanced loans whose principal amount is increased to pay for repairs, the percentage of taxable loss must be reduced by the nontaxable portion of the repairs (in addition to the other adjustments for the nontaxable portion of the original loan). Losses incurred from refinanced loans through a different lender do not qualify for bad debt deductions, nor do losses from refinanced loans where the borrower withdrew any funds other than amounts paid by the lender directly to a repair facility for necessary repairs to the property originally financed.

## **Claims for Refund on SL Accounts**

Generally, returns filed by SL accounts (Certificate of Registration – Lender) qualify as a claim for refund since bad debt losses usually exceed recoveries of previously claimed bad debt losses. The Audit Determination and Refund Section (ADRS) processes a claim for refund with or without detailed verification.

When the account has a prior field examination and the refund being claimed is consistent with the prior examination, ADRS processes the refund without detailed verification. RTC section 6961(b) authorizes the Board to later audit such refund and issue a determination if adjustments are warranted. ADRS notifies the taxpayer accordingly. If inconsistency exists between the claim for refund and the prior examination, ADRS will either contact the lender for additional information or refer the case to the district office for verification.

Audits of SL Accounts are selected on a standard three-year audit cycle. When an account has been selected for audit, ADRS will refer subsequent credit returns (claims for refund) to the appropriate district office in a timely manner. Credit returns outside the audit period will no longer be held by ADRS.

## **Audit Procedures**

When reviewing claims for deduction or refund based on lender bad debts, the auditor should perform the following procedures:

- Carefully review software applications used by claimants to gather information for SL credit return (claim for refund) preparation and consider the impact of such applications on audit results.

The software applications have inherent limitations related to human error, retroactive changes, user specific issues and other factors. In particular, the costs associated with repossessions have been found to be a troublesome area for these applications. The auditor may wish to consult a Computer Audit Specialist for assistance;

- Verify the accuracy of the claim for deduction or refund;
- Confirm the records provided adequately support the claim for deduction or refund;
- Ensure the records provided by the claimant are complete, as required by Regulation 1642(e);
- Confirm that the lender holds a Seller's Permit or a Certificate of Registration – Lender (SL);
- Confirm that there is a valid election agreement on file specifying the claimant is the person entitled to claim the deduction or refund for that account; and
- Verify local and district tax deallocation from the jurisdiction that received the original local or district tax allocation.

For a lender to claim a bad debt deduction or refund, Regulation 1642(i)(2)(B) requires that “the account must have been found worthless and charged off by the lender for income tax purposes.” The standard practice of the lending/financial industry requires bad debts to be written off after a prescribed number of days regardless of any collection activity or payment arrangements made with the debtor, and without regard to whether the account is actually worthless. Thus, although accounts may be written off in accordance with industry standard practice, this does not necessarily mean they are worthless. For example, an account may be written off after the prescribed amount of time has passed, but the lender may have a payment plan in effect with a debtor. Although the account may be written off as a bad debt for other purposes, such an account would not generally be considered “worthless” for purposes of Regulation 1642 while the payment plan remains in effect.

Auditors staff must include in the general comment section of the audit ~~working papers~~ report a comment as to whether the claim for refund qualifies under WFS or Regulation 1642(h)(3) and (i). Both the lender's and retailer's accounts must be cross referenced, indicating the claim for refund, the basis of the claim (WFS or Regulation 1642(h)(3) and (i)), and the periods covered for each. The audit must include a review of the election agreement(s) to ensure each agreement is valid under Regulation 1642(h)(3)(A), (i)(3), or (i)(4)(A), as applicable, and pertains to the transactions under audit.

In addition to the verification of write-offs and recoveries, field examination must include a review of possible use tax liabilities. This review is critical to

educate taxpayers regarding use tax and ensure taxpayers have reported all tax liabilities before claim for refunds are approved. The audit report must include a "use tax" comment.

**Computing the Amount of the Bad Debt Loss:** A lender must provide a listing of all transactions (electronic or hard copy) for which it claims a bad debt deduction or refund, and must also be able to provide source documents for all such transactions. Transactions should be selected for review based on the auditor's discretion and not that of the lender. The amount of the bad debt for which the claim for deduction or refund is filed frequently includes some nontaxable elements (e.g., tax, license, earned or unearned interest, late fees, etc.). It would thus be highly unusual for a lender to be entitled to a bad debt deduction for the entire amount of its losses on an account. Rather, the lender must adjust the amount of ~~its~~ losses so ~~its~~ that claimed deduction includes only the allowable taxable amounts. There are three basic methods of verifying the lender's claim for a bad debt deduction or refund: Actual Basis, Statistical Sampling and Mean Allowable.

Regardless of the method used, prior to beginning verification of the claim, all claimants should be informed that it might later be necessary to expand the size of the sample to ensure a representative sample is taken so the accuracy of the claim is assured. A claimant must be able and willing to provide documentation to support all transactions included in the claim, regardless of accessibility. Transactions for which the claimant is not capable and willing to provide supporting documentation must be disallowed, even in cases where the claimant purports to have documentation but cannot provide copies because they are not readily accessible.

- 1. Actual Basis:** The lender provides a listing of accounts on an actual basis and computes the amount of the allowable bad debt loss on each account on a transaction-by-transaction basis. The information included in the listing must include the items in Appendix 2 of ~~the~~ Regulation 1642, *Bad Debts*. Under this method, the lender computes the claimed bad debt loss for sales and use tax purposes on an actual basis and ~~staff~~ the auditor is verifying ~~verifies~~ the accuracy of the lender's listing. ~~Staff should utilize using statistical sampling techniques, to verify the accuracy of the lender's claimed refund. Staff~~ The auditor must follow the guidelines for performing a statistical sample set forth in Audit Manual AM Chapter 13, *Statistical Sampling*, except for the sample size noted below.

When statistical sampling is used ~~staff~~ the auditor must select a sample size of ~~no fewer than 300 transactions~~ at least 10 percent of the population. ~~If the population is less than 300, the transactions should be examined on an actual basis.~~ The auditor may discover no material discrepancies after testing a sufficient portion of the sample that the auditor is comfortable in concluding the amount of bad debt loss claimed by the taxpayer is correct.

If so, the auditor, in his or her discretion, may terminate the test and accept the amount of bad debt loss claimed by the taxpayer. In reaching this conclusion prior to completing the test, the auditor must consider all factors relevant to the sample, the most important of which is the size and uniformity of the population. When the sample discloses material discrepancies among the lender's listing, the sample differences must be evaluated before projecting to the population. The Board's Statistical Sampling Evaluation program will be used to evaluate the differences. If the sample evaluates well, a percentage of error should be computed and applied to the population of transactions included on the lender's listing to determine the allowable refund amount. If the sample discloses discrepancies and does not evaluate well, ~~staff~~ the auditor should consider expanding the sample.

2. **Statistical Sampling:** The lender has provided a listing of the bad debt accounts written off per their books but they have not computed the allowable bad debt loss as described in Regulation 1642(d). The amount listed may include non-taxable elements such as tax, license, interest, late fees, repossession fees, etc. ~~Staff~~ The auditor must perform a statistical sample of the transactions to compute the allowable portion of the bad debt loss. ~~Staff~~ must follow in accordance with the guidelines for performing a statistical sample set forth in Audit Manual AM Chapter 13, *Statistical Sampling*. However, the auditor ~~Staff~~ must select a sample size to examine no fewer than 300 transactions of at least 10 percent of the population. If the population is less than 300, the transactions should be examined on an actual basis. The lender must provide a listing for the sample that computes the allowable portion of the bad debt on a transaction-by-transaction basis in accordance with Regulation 1642(d). ~~Staff~~ The auditor must verify the accuracy of the sample data.

Under this method, the lender provided the total write off amount for the population. It includes items not allowable under Regulation 1642. The sample is used to compute an audited allowable amount on a transaction-by-transaction basis. Thus every transaction examined in the sample will show a difference between the audited and claimed bad debt. These differences must be evaluated using the Board's Statistical Sampling Evaluation program. When the sample evaluates well, it will be used to compute an audited allowable bad debt percentage. The allowable bad debt percentage is the audited allowable amount per the sample (computed in accordance with Regulation 1642) divided by the total bad debt claimed in the sample. The allowable bad debt percentage will be applied to the total claimed bad debt to arrive at the total audited allowable bad debt amount. If the sample differences do not evaluate well, ~~staff~~ the auditor should consider expanding the sample. On the other hand, the auditor may discover no material discrepancies after

testing a sufficient portion of the sample that the auditor is comfortable in concluding the amount of bad debt loss claimed by the taxpayer is correct. If so, the auditor, in his or her discretion, may terminate the test and accept the amount of bad debt loss claimed by the taxpayer. In reaching this conclusion prior to completing the test, the auditor must consider all factors relevant to the sample, the most important of which is the size and uniformity of the population.

- 3. Mean Allowable:** The third method is similar to the second method described above. Under this method a mean allowable bad debt per account is computed in lieu of an allowable percentage. The verification procedures ~~staff~~the auditor must perform are identical to those described in method two above. When the sample evaluates well, it will be used to compute an audited allowable mean bad debt per account.

The mean allowable amount per account is computed by taking the allowable write off amount per the sample (computed in accordance with Regulation 1642) divided by the total number of accounts examined in the sample. The mean allowable amount per account will be applied to the total number of accounts contained in the population to arrive at the total allowable bad debt. If the sample differences do not evaluate well, ~~staff~~the auditor must expand the sample or provide adequate comments to support the application of the results of the sample.

**Required Documentation – Vehicles:** The following is a list of information ~~staff~~the auditor must review when verifying a claimed bad debt deduction or refund incurred in connection with the financing of a vehicle. However, to the extent this information is not relevant to the actual computation of the allowable bad debt deduction or deallocation of tax, it need not be scheduled. For example, if a statistical sample uses the loan origination number as the basis for selection, this number must be available for all transactions within the population and must be scheduled. If there is a valid reason for not scheduling that information, adequate supporting comments must be included explaining how the information was made available and why it was impractical to include such information in the supporting schedules.

#### **Total Population of Claim on Electronic Media (disc or CD-ROM)**

- Must exclude or readily identify loans that do not qualify
- Must identify loan origination date (date contract entered into)
- Must include seller's/dealer's name and address (city and state)
- Must include consumer's name and address (city and state)
- Must include the following additional information:
  - Reference number – number assigned to each loan
  - Type of vehicle/property – e.g., vehicle, RV, mobile home, etc.
  - Date of repossession charge off – the date charged off for income tax

- purposes
- Loan number – actual loan account number
- Charge off or loss per records – amount charged off for income tax purposes
- Summarized number of transactions in each local tax and district tax area

### **Sample Selection**

- Minimum sample size of ~~300~~ 10 percent of loan contracts (population) selected using statistical sampling procedures (i.e., random, systematic with random start, etc.). ~~If the total population is equal to or less than 300, verification will be on an actual basis.~~
- For each loan in the sample — evidence that the uncollectible portion has been charged off for income tax purposes or in accordance with GAAP. Printouts from taxpayer accounting system will suffice.
- For losses claimed under Regulation 1642(h)(3) and (i), an election agreement for each loan as required by Regulation 1642 (i)(3)(A) and, if applicable, the election agreement required by either Regulation 1642 (h)(3)(A) or (i)(4)(A).

### **Documentation and Information for Selected Sample**

- Complete contract file, including the “No Recourse” statement. If “No Recourse” statement is not available, copy of the contract/agreement between dealer and the financial institution establishing that the lender holds the account without recourse.
- Reference number – number assigned to each loan
- Loan origination date – date contract entered into
- Date of repossession charge off – the date charged off for income tax purposes
- Loan number – actual loan account number
- Sales price of vehicle – total amount subject to tax including document preparation charge and taxable smog
- Nontaxable charges such as charges for optional service contracts, ~~Smog Impact Fee~~, Smog Check Certificate fee, etc.
- Sales tax reimbursement collected from the consumer on sale
- Vehicle License Fee
- Insurance – net amount
- Down payment

- Any adjustments to the principal
- Finance charges – net amount
- Payments on principal
- Value of repossession – sales price for subsequent sale
- Charge off or loss per records – amount charged off for income tax purposes
- Repossession expense – auctioneer’s fees, reconditioning, etc.
- Recovery – payments made after the loan is charged off on records
- Reversals – adjustments for non-sufficient funds (NSF) checks, etc.
- Taxpayer must compute the amount of refund per Regulation 1642

**Local Tax Verification:** When reviewing a claim for refund under WFS or Regulation 1642(h)(3) and (i), it is imperative the local and district taxes are properly deallocated. For example, when the claimed bad debt loss relates to sales of vehicles, the name and address of the dealer and consumer must be included for each transaction scheduled to properly deallocate the local and district taxes on an actual basis. For loans approved by the lender on a transaction-by-transaction basis, the lender should allocate the local and district taxes on an actual basis. In cases where transaction-by-transaction information is not available and the deallocation cannot be done on an actual basis, the regulation provides that the lender may allocate local and district taxes on an appropriate basis subject to approval by the Board. When verifying the accuracy of such an alternative method, the field auditor must fully explain (1) the basis for concluding whether the alternative method is accurate and (2) specifically how the local tax deallocation was calculated.

## MANAGED AUDIT PROGRAM

0435.00

The board's first ~~Managed Audit Program~~ (~~MAP~~) was available to taxpayers from January 1, 1998 to January 1, 2003. There was no ~~MAP~~ in 2003. Beginning January 1, 2004, the ~~MAP~~ was reinstated through December 31, 2009. The new ~~MAP~~ differs from the previous program in that in the new program:

- Prepayment accounts may participate ~~in the MAP~~.
- The Board may grant relief of liability under RTC section 6596 in cases where taxpayers who have participated in the MAP rely on erroneous advice from the Board and fail to pay amounts due.

The information in the following AM sections reflects the provisions of the MAP beginning January 1, 2004.

### MANAGED AUDIT PROGRAM – GENERAL

0435.05

A managed audit is essentially a self-audit. Under the direction of ~~a Board~~ the auditor, an eligible taxpayer is provided written and oral instructions to enable the taxpayer to perform the audit verification and prepare the ~~working paper~~ AWPs ~~schedules~~ necessary to complete a particular portion of the audit. The advantages to the taxpayer and to the state include the following:

- It is less likely that the taxpayer will feel it necessary to take audit issues through the administrative appeals process or litigate audit findings.
- The auditor will spend fewer hours on the audit and fewer hours at the taxpayer's business.
- Questions of taxability are more likely to be resolved during the audit process.
- The taxpayer is likely to become more knowledgeable about how the sales and use tax affects his/her business.
- Because of the knowledge gained from the managed audit, it is less likely that the taxpayer will be out of compliance in those areas he/she has audited.
- The taxpayer will be more familiar with the audit process.
- It is likely that a more cooperative, ongoing relationship with the Board will be established.
- Where a liability is disclosed, interest will be computed at one-half the normal rate.
- RTC ~~S~~section 6596 relief may be provided in cases where taxpayers who have participated in the MAP rely on erroneous advice from the Board and fail to pay amounts due.

### ELIGIBLE ACCOUNTS

0435.10

It is extremely important that the auditor conduct a thorough review of the taxpayer's operations prior to proceeding into the managed audit process. Taxpayers should not be considered a candidate for the managed audit process if their business operations consist of transactions which require an in depth knowledge of the law.

While it is the auditor's responsibility to determine whether a taxpayer is eligible to participate in a managed audit, a taxpayer may initiate the review process by requesting a managed audit be conducted. For example, taxpayers seeking a tax clearance or who have been notified of audit may wish to conduct a managed audit to expedite the clearance or routine audit process. ~~Staff~~ The auditor should consider all reasonable requests for participation, keeping in mind our primary goal is the cost savings in ~~staff-audit~~ hours that can be used to perform other productive audits. Accordingly, interested taxpayers should submit their request for participation to the appropriate District Administrator/District Principal Auditor. In that application, the taxpayer is required to clearly explain how they meet the statutory requirements of RTC Section 7076.

Accounts that may be eligible for the MAP shall include those meeting all of the following criteria:

- Any person whose business involves few or no exemptions;
- Any person whose business involves a single or small number of clearly defined taxability issues;
- Any person who agrees to participate in the MAP; and,
- Any person who has the resources to comply with the managed audit instructions provided by the Board.

Examples of situations in which a managed audit should not be used include cases where:

- The taxpayer's books and records are inadequate;
- The taxpayer has complex issues relating to the allocation or reallocation of local tax;
- The taxpayer is a business with inadequate achieved markups;
- The issues involved are very complex (for example, research and development contracts); or
- There is a question regarding negligence or intentional underreporting (fraud).

Although eligibility provisions contain some restrictive language, this should be balanced with the taxpayer and/or representative's level of sophistication in understanding and dealing with any issues that may arise. Any inquiries regarding the eligibility of an account for the MAP should be sent by the District Principal Auditor to the Chief, Tax Policy Division, ~~(with a "cc" copy~~ to the Chief, Field Operations Division, Equalization Districts 1 and 2 and Out-of-State

## **APPLICATION OF INTEREST AND PENALTIES**

0435.15

### **(a) Interest**

If a tax liability is disclosed as a result of an approved MAP audit, and the audit is completed pursuant to the participation agreement, interest will be computed at one-half the normal statutory interest rate for the total unreported tax liability. Interest will be calculated using the standard interest rate calculation rules, but at one-half the normal rate until the tax liability is paid in full unless the Board voids the agreement.

The one-half interest rate will apply even if the entire audit was not performed under a MAP audit and even if the portion performed by the auditor results in a tax liability. For example:

- An audit is conducted on a manufacturer whose only deduction is for sales for resale.
- It is agreed that the taxpayer will perform a managed audit of sales for resale and asset purchases, which discloses additional tax liability. This review would normally comprise a substantial portion of the audit if performed by the auditor.
- The review of lease transactions by the auditor also discloses additional tax liability. This portion of the audit is not deemed to be conducive to taxpayer review, and does not entail much expenditure of time by the auditor.

Under these circumstances the entire tax liability would be computed at the one-half interest rate since there was a MAP Participation Agreement. If the Board determines that the taxpayer fails to comply with the provisions of the agreement or complete its portion of the MAP and the auditor finds it necessary to perform a significant amount of verification, the one-half interest rate will not apply. This will also be true if a negligence or fraud penalty is imposed during the audit period. (See AM section 0435.20(b).)

If the MAP audit results in a credit or refund, the standard net running balance method will be used to compute interest. If the audit has both debit and credit periods, the one-half interest rate would apply for debit periods and the full statutory credit interest rate would apply for credit periods.

### **(b) Penalties**

There is no change to procedures for applying penalties as warranted under the MAP. However, if after their preliminary review of records, the auditor believes that the taxpayer was negligent, a managed audit should not be conducted. Nor should the managed audit be used if the auditor

believes there was fraud during the audit period.

### (c) Petitions for Redetermination or Claims for Refund

There is no change to procedures for filing timely petitions or claims for refund for managed audits.

## AUDIT PROCEDURE

0435.20

It is primarily the responsibility of the auditor to determine whether a taxpayer should be considered for the MAP. The auditor's immediate supervisor is responsible for approval of the auditor's recommendation. This information must be documented by the auditor ~~in on the~~ Form BOE-414-Z, Assignment Contact History. ~~(Form BOE 414 Z).~~

### (a) Preliminary Review

As part of the normal audit procedure, auditors will review the taxpayer's operations and determine whether the taxpayer meets the minimum eligibility requirements ~~are met (as described in AM Ssection-III) 0435.10. for the MAP.~~ This includes a facility tour (if appropriate); a review of the chart of accounts, general ledger, Federal Income Tax returns, sales journals, sales invoices, depreciation schedules, purchase invoices, sales and use tax returns, and reporting procedures; and an evaluation of the taxability of the sales and/or purchases, as well as of the taxpayer's knowledge and understanding of the tax laws applicable to the transactions being reviewed. In addition to the minimum eligibility requirements for the MAP, the taxpayer must also agree to perform a significant portion of the audit.

~~The Auditor staff~~ may also consider the use of a Computer Audit Specialist to improve audit efficiency (reduce audit hours); if the account meets the criteria outlined in ~~Audit Manual~~ AM section 1304.40.

If all or a portion of the audit is allowed under MAP, any resulting tax liability, even for those areas of non-MAP, will be computed at the one-half interest rate. For this reason, the auditor must exercise good judgment in considering accounts for eligibility under the MAP.

Following is an example of a taxpayer that would not be eligible under the MAP:

- An audit is conducted on a manufacturer whose only deduction is for sales for resale.
- After initial review of records, the auditor finds significant problems with the taxpayer's internal controls, missing sales invoices, and/or a total lack of documentation to support claimed resales.
- It is necessary for the auditor to perform the test of resales, and this will involve a significant amount of time — similar to time that would normally be expended on the audit.

- Also during the review, the auditor finds there are very few purchases that may be subject to use tax and that this will involve an amount of time similar to that on an audit.

In this case, the taxpayer should not be considered for a MAP audit and/or receive the benefit of the one-half interest rate because participation in a MAP would be of little benefit to the State in reduction of audit hours.

### **(b) Managed Audit Program Participation Agreement**

After the auditor has discussed the taxpayer's eligibility for the MAP with his/her supervisor and they are in agreement with the taxpayer's participation, the taxpayer should be presented with Publication 53, *Guide to the Managed Audit Program* which includes the ~~Form BOE-526~~. *Managed Audit Program Participation Agreement* (~~Form BOE-526~~). The provisions of the MAP should be explained to the taxpayer. If the taxpayer agrees to participate in the MAP, Form BOE-526 will be completed by the auditor with the following information:

- Taxpayer's name and account number;
- Audit period;
- A reasonable time period (generally within 90 days) the taxpayer is allowed to complete the work; ~~however~~ However, the auditor staff should use ~~their~~ his or her discretion to accommodate larger business operations;
- Deadlines to complete the review of each transaction type or record, e.g., claimed deductions, purchases of consumable supplies, etc.;
- Information on the types of transactions and records to be reviewed; and
- The method for review and the periods for the records to be reviewed.

~~This~~ The MAP participation agreement will then be signed and dated by the taxpayer and the District Principal Auditor. A copy of the signed agreement will be provided to the taxpayer. The original signed agreement and a copy must be attached to the Headquarters' audit report packet, with a copy retained in the audit report working papers (see AM section 0213.03).

The Board may void the MAP participation agreement if it determines that:

- The taxpayer has failed to complete the managed audit by the due date in accordance with the provisions in this agreement.
- The apparent nature and/or complexity of the taxpayer's operations and/or transactions require greater levels of review, research, or verification than was originally anticipated;
- The taxpayer has refused to cooperate with the Board during the verification process described in paragraph 4 of the agreement or has

refused to cooperate with the Board if it audits any transactions pursuant to paragraph 5 of the agreement;

- Any penalties for negligence or fraud are imposed during the audit period under RTC sections 6484, 6485, 6485.1, or 6514.1;
- There is jeopardy of collection under 6536; or
- The payment of the liabilities and interest was not made within the time period specified by the Board.

At least 15 days prior to the completion date indicated in the MAP participation agreement, the auditor's supervisor will send the taxpayer a letter reminding the taxpayer that the managed audit must be completed and documented by the mutually agreed upon completion date. If the review is not completed by the agreed upon date, the MAP participation agreement will be voided and the full interest rate will apply to any audit liability.

If the taxpayer requests an extension of the agreed upon completion date, they must obtain approval from the District Principal Auditor. If an extension is approved, the MAP participation agreement should be revised to reflect the new completion date.

The auditor will document the taxpayer's actions on Form BOE-414-Z, *Assignment Contact History*.

~~Before the Board can voids a MAP participation agreement, a summary of the specific circumstances of the case and reasons for voiding the MAP agreement must be provided to and approved by the Chief, Field Operations Division, Equalization Districts 1 and 2 and Out-of-State District or the Chief, Collections and Third District Field Operations Division, Equalization Districts 3 and 4 and Centralized Collection Section. If the MAP agreement is voided, the taxpayer will not be entitled to the one half interest rate. Upon approval by the appropriate Chief, The taxpayer's actions should be documented on form BOE 414 Z, and the taxpayer should be notified in writing by the District Principal Auditor will send the taxpayer a written notification of the termination of that the MAP Pparticipation Agreement, is terminated with an explanation of and the reasons for such termination. The front of the audit report should continue to be marked as a managed auditMAP for program evaluation purposes with an explanation for the termination shown on the back of the audit report. Also, the AUD MC screen in IRIS should have the flag set to "N" for managed audit, otherwise, the reduction in the interest rate will be triggered.~~

Participation in the MAP is voluntary on the part of the taxpayer. None of the above actions by the taxpayer should have a negative impact on how the audit is completed or the scope of the audit verification to be performed by the auditor. The only impact will be that the taxpayer will

not receive the benefit of the one-half interest rate should the audit result in a tax liability.

**(c) Verification of Taxpayer's Examination**

A very important factor for the success of the MAP is the verification of work performed by the taxpayer. While it is not expected, nor necessary, that the auditor check 100 percent of the work performed by the taxpayer, the auditor should conduct a review of the work to the extent that the auditor is satisfied that the work performed is accurate. This verification should confirm that the instructions provided to the taxpayer were followed accurately and that any problem areas of taxability were sufficiently addressed. The auditor should instruct the taxpayer to separately maintain the records (sales invoices, purchase orders, resale certificates, etc.) that the taxpayer used in its examination until the auditor verifies the taxpayer's examination.

**(d) Audit Comments**

The verification comments should describe test and verification procedures used by the taxpayer and auditor. In addition, comments should be made regarding any discussions with the taxpayer regarding areas of underreporting.

**(e) Audit Report**

The audit report should be prepared by the auditor and transmitted using normal procedures; however, a notation should be made on the top right corner on the front page of the audit report indicating that this is a managed audit.

~~(f) District Audit Review~~

The Audit Determination and Refund Section will ensure that the interest calculation is correct for all managed audits and that the "interest through date" is correct prior to billing. Once the audit report is approved for billing, a copy of the audit report and the MAP Participation Agreement will be made and forwarded to the Chief, Tax Policy Division (with a "ee" copy to the Chief, Field Operations Division, Equalization Districts 1 and 2 and Out-of-State District or the Chief, Collections and Third District Field Operations Division, Equalization Districts 3 and 4 and Centralized Collection Section for evaluation of the MAP.



STATE OF CALIFORNIA

## STATE BOARD OF EQUALIZATION

SALES AND USE TAX DEPARTMENT

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### Use of Sampling in Auditing

The primary purpose behind the Board of Equalization's audit program is to determine, with the least possible expenditure of time for both the taxpayer and the Board, the accuracy of reported amounts. Sampling serves to accomplish this purpose.

Sampling is a process of drawing a conclusion about an entire body of information based on measurements of a representative sample of that information. Sales and use taxes are transaction taxes, meaning that tax is determined on a transaction-by-transaction basis. Therefore, verification must be done at the source document level. Since in many cases it is economically impractical to audit all transactions, the Board encourages the use of sampling whenever feasible.

There are generally two methods of sampling: judgment sampling and statistical sampling. A judgment sample includes all samples obtained by nonstatistical sampling methods. The most common type of judgment sample is the examination of a block period of time (for example, day, week, month, or quarter). A statistical or random sample is a sample in which each item in the population has an equal or known chance of being selected for examination. Examples of statistical or random sampling techniques include unrestricted sampling, stratified sampling, systematic sampling with random start, and cluster sampling.

While judgment samples are not necessarily less accurate than statistical samples, there is no way of objectively evaluating the accuracy or reliability of the test. The advantages of statistical sampling over non-statistical sampling are:

- It provides a selection process which is representative of the types of transactions involved and eliminates bias, since every item in the population has an equal or known chance of being selected.
- It provides an advance estimate of the sample size required for a given objective.
- The results can be objectively evaluated.
- Multiple samples may be combined and evaluated.
- Properly conducted statistical sampling can yield more reliable results than judgment sampling.
- It is a method approved and recommended by the American Institute of Certified Public Accountants (AICPA).

Other factors to be considered in determining the best type of sample to conduct are the format, condition, storage, and availability of business records. The auditor and taxpayer should discuss the most beneficial approach to examining source documents after the auditor has had an opportunity to review the business records but prior to the selection of the sample.

The attached BOE-472, *Audit Sampling Plan*, was developed to facilitate the use of sampling by helping the auditor and taxpayer to document the sampling plan and to set the criteria by which the sample results will be evaluated. The purpose of this form is to obtain information regarding the taxpayer's operations in order to establish the most effective and efficient means of developing a sampling plan. The form covers many common situations that might arise in sampling and should be discussed with the taxpayer. This form should be completed with the assistance of the taxpayer, prior to the selection of the sample.

The information and methods documented in this form are not binding on either the taxpayer or Board staff. The sampling plan can, and should, be continually evaluated (and changed, if necessary) based upon information obtained during the auditing process. In addition, it is possible that stratification or expansion of this sample may become necessary depending on the results produced by this process. However, should any deviation to this plan be required, it will be fully discussed with the taxpayer.

If you have any questions regarding this form and accompanying information, please contact your auditor.

TAXPAYER NAME	SCHEDULE NUMBER
AUDIT PERIOD to	ACCOUNT NUMBER

The purpose of this form is to establish the most efficient means of developing a sampling plan. Please complete all sections below.

1. Define the objectives of this test, including population to be tested:

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2. The sample period and records to be examined in performing this sample include the listed items, but these items may be modified if new or additional information is discovered:

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a) Filing method used for the population:

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3. The sampling unit will be:

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4. The method of selecting the sampling unit tested will be:

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TAXPAYER NAME	SCHEDULE NUMBER
AUDIT PERIOD to	ACCOUNT NUMBER

a) If you plan to conduct a statistical sample, identify the procedure(s) to be used:

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b) If you plan to conduct a block test, please list the reasons why a statistical test was not possible:

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5. The statistical sample size will be:

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a) The method and/or reason for determining the above sample size:

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6. If a block sample is used, list the selected test period(s):

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7. The sample base will be:

**Units:** \_\_\_\_\_

**Dollars:** \_\_\_\_\_

TAXPAYER NAME	SCHEDULE NUMBER
AUDIT PERIOD to	ACCOUNT NUMBER

8. The population base will be:

**Units:**

**Dollars:**

9. The Board has a policy requiring a minimum of three errors in a sample or stratum (excluding actual basis examinations and cluster samples) for that sample or stratum to be projected.

a) If three or more errors are found in the sample or stratum, the results of the sample will be projected using the following procedures:

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b) If less than three errors are found in the sample or stratum, the auditor will use one of the alternatives listed below to handle the errors in that sample or stratum. The auditor, if necessary, will discuss the alternatives with the taxpayer after the sample results are known and then make a decision on the alternative to use.

- Examine specific customers, vendors, accounts, known errors, etc., on a detailed basis for that sample or stratum.
- If feasible, expand that sample or stratum.
- Accept the reported/claimed amounts for that sample/stratum, if the circumstances warrant.

10. The following procedures will be used for the treatment of some specific situation(s) should they occur. Any additional items will be addressed in Section 11, "Other."

a) Duplicate sample units (sampling with or without replacement):

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b) Missing sample unit(s):

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TAXPAYER NAME	SCHEDULE NUMBER
AUDIT PERIOD to	ACCOUNT NUMBER

c) Sample unit is a void or canceled transaction:

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d) Sample unit is an error but the transaction is corrected at a later date:

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e) Sample unit is a "credit" item:

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f) Sample unit is a partial/down/installment or progress payment:

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g) Sample unit is for "tax" only:

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h) Sample unit is an error but the transaction later resulted in a bad debt:

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TAXPAYER NAME	SCHEDULE NUMBER
AUDIT PERIOD to	ACCOUNT NUMBER

11. Other:

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This sampling plan is a collaborative effort by the auditor and taxpayer to determine the most efficient method of establishing an estimated percentage of error, if any, for the population being tested. The information and methods documented in this form are not binding on either the taxpayer or Board staff. This sampling plan may be modified if new or additional data is encountered. Should any deviation to this plan be required, it will be fully discussed with the taxpayer.

A copy of this sampling plan was provided to the taxpayer on \_\_\_\_\_  
DATE

\_\_\_\_\_  
AUDITOR'S SIGNATURE

\_\_\_\_\_  
TAXPAYER'S SIGNATURE FOR RECEIPT OF COPY

**Audit Manual**  
**EXAMPLES OF PRIOR AUDIT PERCENTAGE MEMOS**

**EXHIBIT 6**  
Page 1 of 2

State of California

Board of Equalization

**Memorandum**

**To :** District Principal Auditor

**Date:** December 1, 20XX

**From :** Audit Supervisor

**Subject :** **Request to Use a Prior Audit Percentage**  
**ABC Company SR KH 12-345678**

We would like to use a prior audit percentage in the current audit of ABC Company. Staff has reviewed their accounting procedures and determined that there has been no change since the last audit. In addition, there have been no changes to the personnel handling their accounts payable and there have been no changes to any laws or regulations affecting their business. The following is an outline of our proposal as specified in Audit Manual Section 0405.33:

- (a) ABC Company SR KN 12-345678.
- (b) The taxpayer is a manufacturer and distributor of consumer electronics.
- (c) The audit period is 1/1/00 - 12/31/02.
- (d) The prior audit percentage would be used in the paid bills portion of the audit.
- (e) For the prior audit period, 1/1/97 - 12/31/99, the percentage of error was 2.01 percent.
- (f) For the prior audit period, 1/1/97 - 12/31/99, the population was \$4,100,000.
- (g) We propose the use of 2.01 percent in the current audit.
- (h) The population to which this percentage of error will be applied is \$5,600,000.

We have discussed this approach with the tax manager and she is agreeable to the use of the prior percentage of error. The tax manager was informed that this approach would not be used in consecutive audits. We both agree that given the relative consistency in the error rates, populations, accounting procedures, internal controls and personnel, the use of a prior percentage of error would save significant audit time while achieving substantially the same result as a new test.

Thank you for your consideration. Please let me know if you have any questions.

Approved: \_\_\_\_\_

Date: \_\_\_\_\_

cc: I. M. Auditor

GENERAL AUDIT PROCEDURES

(CONT.) EXHIBIT 6  
Page 2 of 2

State of California

Board of Equalization

**Memorandum**

**To :** Chief, Tax Policy Division, (MIC: 92)

**Date:** December 1, 20XX

**From :** District Principal Auditor

**Subject :** Use of a Prior Audit Percentage  
ABC Company SR KH 12-345678

We have completed our audit of ABC Company for the period of January 1, 2000 through December 31, 2002. The prior audit error percentage was used in the paid bills portion of this audit. The tax change resulting from the use of the prior audit error percentage is \$8,723. We estimate that a total of 40 audit hours were saved by utilizing this method.

Please let me know if you have any questions.

Attachment: December 1, 20XX Memo from Audit Supervisor to District Principal Auditor requesting use of prior audit percentage for ABC Company

cc: Chief, Field Operations Division  
Equalization Districts 1 and 2  
Out-of-State District (MIC 47), or

Chief, Field Operations Division  
Equalization Districts 3 and 4  
Centralized Collection Section (MIC 46)

I.M. Auditor



STATE OF CALIFORNIA

**STATE BOARD OF EQUALIZATION**450 N STREET, SACRAMENTO, CALIFORNIA  
PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-00XX  
916-XXX-XXXX • FAX 916-XXX-XXXX  
www.boe.ca.govBETTY T. YEE  
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Second District, Ontario/SacramentoMICHELLE STEEL  
Third District, Rolling Hills EstatesJUDY CHU, Ph.D.  
Fourth District, Los AngelesJOHN CHIANG  
State ControllerRAMON J. HIRSIG  
Executive Director**Tax Permittee****Use of "ABC" Letter Procedure to Verify Payment of Use Tax by Out-of-State Sellers**

This letter summarizes the sample letter procedure explained to you by our auditor. The auditor questioned certain ex-tax purchases made by you. Under the California Sales and Use Tax Law, you as the purchaser are liable for payment of the tax unless you can present satisfactory evidence (e.g., a receipt) that the tax was paid to a seller holding a California seller's permit or a Certificate of Registration-Use Tax.

The "ABC" letter procedure outlined in this document is recommended by the Board as a method by which you, the purchaser, can help to satisfy your use tax obligation. You are not bound to use these procedures and can present any other satisfactory evidence, such as a receipt.

The attached sample letter (BOE-503-B) and statement form (BOE-503-C) are provided for your convenience. You may reproduce the statement form and send it to the vendor(s) in question to obtain their signed statements regarding the payment of use tax. If you choose the recommended procedure to have the forms returned directly to the Board, the auditor will provide return envelopes. However, if you decide to use the "ABC" process and you choose to have the forms returned directly to you instead of the Board, the likelihood of having staff contact your vendor or sending an additional mailing will be greater. In order to communicate fully with your vendor(s), you may:

- Customize the letter by placing the text on your letterhead.
- Choose the recommended procedure to have the responses sent directly to the Board, and add a statement in the letter to your vendor(s) asking that your vendor(s) send you a copy of their response by fax or mail.

Please note that any changes you make to the sample letter or form must be approved by Board staff before mailing.

The auditor will allow a four week period for you to send the statements and for your vendor(s) to reply. If you have chosen the recommended procedure to have the responses sent directly to the Board, the auditor will timely provide you with copies of the responses received. While the auditor will carefully consider the statements received within the allowed period, late responses may be reviewed and allowed if appropriate.

Please be aware that a statement will not be accepted as satisfactory proof if incomplete, if found to be untrue, or if the Board has or receives information that refutes such statement. An "ABC" response merely acts as one form of evidence of possible tax payment by the vendor and does not preclude further analysis and verification by the auditor.

STATE BOARD OF EQUALIZATION  
Sales and Use Tax Department



STATE OF CALIFORNIA

## STATE BOARD OF EQUALIZATION

[ADDRESS 1]

[ADDRESS 2]

[REQUESTER PHONE NUMBER] • FAX [OFFICE FAX NUMBER]

www.boe.ca.gov

BETTY T. YEE  
First District, San FranciscoBILL LEONARD  
Second District, Ontario/SacramentoMICHELLE STEEL  
Third District, Rolling Hills EstatesJUDY CHU, Ph.D.  
Fourth District, Los AngelesJOHN CHIANG  
State ControllerRAMON J. HIRSIG  
Executive Director**Tax Permittee****Use of "XYZ" Letter Procedure to Verify Claimed Sales for Resale**

This letter summarizes the sample letter procedure explained to you by our auditor. The auditor questioned certain sales claimed on your tax returns as sales for resale because they were not supported by a valid resale certificate taken in good faith at the time of sale.

Under the California Sales and Use Tax Law, you as the seller are liable for payment of the tax unless you can present satisfactory evidence that the property was in fact purchased by your customer for resale or that your customer paid the tax directly to this state.

If the auditor has also questioned sales other than resale, such as sales in interstate and foreign commerce, sales to the United States Government, or transportation charges, documentation to support the claimed exemption must also be provided. The auditor will provide you with an information sheet describing how the law applies and the type of supporting documentation required to support the questioned claimed exempt sale.

The "XYZ" letter procedure outlined in this document is recommended by the Board as a method by which you, the seller, can help to satisfy the burden of proving that a sale was not at retail even though a resale certificate was not timely obtained, or your customer paid the tax directly to the state. This procedure should only be used when you cannot locate the appropriate supporting documentation, such as resale certificates, purchase orders, sales contracts, etc., within your company records.

It is recommended that the "XYZ" response forms be returned directly to the Board. However, you may choose to have the letters returned to you for forwarding to the Board. In either case, the auditor will review all documentation submitted. Because the XYZ letter is not a substitute for a timely resale certificate, you or your customer may be required to submit additional documentation or information to your auditor. You should be aware that if the auditor determines the "XYZ" process is appropriate and you choose to have the forms returned directly to you instead of to the Board, the likelihood of having staff contact your customer or sending an additional mailing will be greater.

The attached sample letter and statement form are provided for your convenience. If the statement form does not fit your particular circumstances, the auditor will work with you to customize the form. You may reproduce the statement form and send it to the customers in question to obtain their signed statements regarding the disposition of the purchased property. If you choose the recommended procedure to have the forms returned directly to the Board, the auditor will provide return envelopes.

In order to communicate fully with your customers, you may

- Customize the letter by placing the text on your letterhead.
- If you choose the recommended procedure to have the responses sent directly to the Board, you may add a statement in the letter to your customer asking that your customer send you a copy of the response by fax or mail.
- If your agreement of sale permits it, ask your customer to forward payment of tax if the transaction is identified as taxable. You should clearly indicate that the tax should be forwarded to you and not to the Board of Equalization.

Please note that any changes you make to the sample letter or form must be approved by Board staff before mailing.

The auditor will allow a four week period for you to send the statements and for your customers to reply. If you have chosen the recommended procedure to have the responses sent directly to the Board, the auditor will timely provide you copies of the responses received. While the auditor will carefully consider the statements received within the allowed period, late responses may be reviewed and allowed if appropriate.

Please be aware that a statement will not be accepted as satisfactory proof if incomplete, if found to be untrue, or if the Board has or receives information that refutes such statement. Unlike a valid resale certificate, a purchaser's statement of resale taken after the sale does not relieve the seller of liability for the tax if it is found that the property was purchased for the buyer's use and the applicable tax was not paid to the state prior to the date of your letter to your customer.

STATE BOARD OF EQUALIZATION  
Sales and Use Tax Department

SAMPLE LETTER  
Requesting Purchaser's Statement

XYZ Company  
1234 5th Street  
Los Angeles, California 90013

Auditors of the California State Board of Equalization are currently examining our records in connection with the California Sales and Use Tax Law. They have questioned certain nontaxed sales made to you, as covered by the invoices listed on the attached sheet.

Would you please indicate the disposition of this property by checking the appropriate box and completing the statement. The board will **not** accept the statement if it is not filled out completely and signed by an authorized representative.

Your prompt response is necessary to support any claims for exemption that are in order. Please return the inquiry statement within 10 days using the enclosed envelope or fax to (\_\_\_\_) \_\_\_\_\_.

**STATEMENT CONCERNING PROPERTY PURCHASED WITHOUT PAYMENT OF CALIFORNIA SALES TAX**

DMA \_\_\_\_\_

Auditor's Initials \_\_\_\_\_

*Please complete this inquiry statement to indicate the disposition of certain non-taxed purchases you made from the seller listed below. Please fill out the form completely, check the appropriate boxes, and sign as your company's authorized representative. The form should be returned within 10 days.*

NAME OF SELLER FROM WHOM YOU PURCHASED ITEMS WITHOUT SALES TAX	SELLER'S PERMIT NUMBER
--	------------------------

DATE	INVOICE NUMBER	PURCHASE ORDER NUMBER	AMOUNT	DESCRIPTION

*Please check the appropriate box(es) below. If none of these apply, please explain below.*

- The above property was purchased for resale and was resold in the form of tangible personal property. It was not used for any purpose other than retention, demonstration, or display while being held for sale in the regular course of business.
- The above property was purchased for resale and is presently in resale inventory. It has not been used for any purpose other than retention, demonstration, or display while being held for sale in the regular course of business.
- The above property was purchased for leasing and tax measured by rental receipts has been paid directly to the Board with our sales tax returns.
- The above property was purchased for our own use and not for resale; and
  - tax in the amount of \_\_\_\_\_ was paid directly to the Board with our sales tax return for the reporting period \_\_\_\_\_.
  - tax in the amount of \_\_\_\_\_ was added to the billing and remitted to the Seller.
  - the purchase is a taxable transaction and tax is applicable.

COMMENTS

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NATURE OF BUSINESS

PURCHASER'S SALES TAX PERMIT NUMBER	PURCHASER'S NAME
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SIGNATURE	TITLE
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DATE	PHONE	CITY
------	-------	------

*The information provided above is subject to verification by the State Board of Equalization.*

**STATEMENT CONCERNING PROPERTY PURCHASED  
WITHOUT PAYMENT OF CALIFORNIA SALES TAX**

DMA \_\_\_\_\_  
Auditor's Initials \_\_\_\_\_

*Please complete this inquiry statement to indicate the disposition of certain non-taxed purchases you made from the seller listed below. Please fill out the form completely, check the appropriate boxes, and sign as your company's authorized representative. The form should be returned within 10 days.*

NAME OF SELLER FROM WHOM YOU PURCHASED ITEMS WITHOUT SALES TAX				SELLER'S PERMIT NO.
DATE	INVOICE NUMBER	PURCHASE ORDER NUMBER	AMOUNT	DESCRIPTION

*Please check the appropriate boxes below. If none of these apply, please explain below.*

- The above property was purchased for resale and was resold in the form of tangible personal property. It was not used for any purpose other than retention, demonstration, or display while being held for sale in the regular course of business.
- The above property was purchased for resale and is presently in resale inventory. It has not been used for any purpose other than retention, demonstration, or display while being held for sale in the regular course of business.
- The above property was purchased for leasing and tax measured by rental receipts has been paid directly to the Board with our sales tax returns.
- The above property was purchased for leasing and tax measured by the purchase price has been paid directly to the Board with our sales tax return for the period in which the property was first leased.
- The above property (not "mobile transportation equipment") was purchased for leasing to a sublessor.
- The above property ("mobile transportation equipment") was purchased for leasing and tax measured by the fair rental value has been paid directly to the Board with our sales tax return for the period in which the equipment was first leased.
- The above property was purchased for our own use and not for leasing or resale, and
  - tax in the amount of \_\_\_\_\_ was paid directly to the Board with our sales tax return for the reporting period
  - \_\_\_\_\_
  - tax in the amount of \_\_\_\_\_ was added to the billing and remitted to the Seller.
  - the purchase is a taxable transaction and tax is applicable.

COMMENTS

NATURE OF BUSINESS		
PURCHASER'S SALES TAX PERMIT NUMBER		PURCHASER'S NAME
SIGNATURE		TITLE
DATE	PHONE	CITY

*The information provided above is subject to verification by the State Board of Equalization.*

SAMPLE LETTER FOR SPECIAL PRINTING AIDS  
**Requesting Purchaser's Statement**

XYZ Company  
1234 5th Street  
Los Angeles, California 90013

The California State Board of Equalization is currently examining our records for compliance with the California Sales and Use Tax Law. They have questioned certain nontaxed sales of special printing aids made to you as indicated on the invoices listed on the attached sheet. These nontaxed sales are not supported by a valid resale certificate.

Please indicate the disposition of these special printing aids by placing the applicable letter in the corresponding response column for each invoice listed.

Unless printers specifically state that they are retaining title to the special printing aids on their customer's contract or sales invoice, printers are considered the retailers of the special printing aids and may purchase special printing aids for resale. However, special printing aids are considered purchased for the purchaser's own use and not for resale if the purchaser:

- Only resells printed material and not special printing aids. For example, book/newspaper publishers or manufacturers purchasing product labels or packaging for resale with the product. The printed material is resold, but the publisher or manufacturer is the end user of the special printing aids
- Buys the printed matter for their own use
- Is a print broker who resells the printed material but maintains ownership of the special printing aids

Your prompt response is necessary to support any claims for exemption. The board will **not** accept the statement if it is not filled out completely and signed by an authorized representative. Please return the inquiry statement within 10 days using the enclosed envelope or fax to (\_\_\_\_)

\_\_\_\_\_.

Sincerely,

Encl:

**STATEMENT CONCERNING PROPERTY PURCHASED  
WITHOUT PAYMENT OF CALIFORNIA SALES TAX – SPECIAL PRINTING AIDS**

DMA \_\_\_\_\_  
Auditor's Initials \_\_\_\_\_

Please complete this inquiry statement to indicate the disposition of certain non-taxed purchases you made from the seller listed below. Please fill out the form completely and sign as your company's authorized representative. The form should be returned within 10 days.

NAME OF SELLER FROM WHOM YOU PURCHASED ITEMS WITHOUT SALES TAX	SELLER'S PERMIT NO.
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DATE	INVOICE NUMBER	PURCHASE ORDER NUMBER	AMOUNT	DESCRIPTION	RESPONSE <i>List boxes (a) through (i) that apply</i>

Please place the appropriate letter and information in Response area above. If none of these apply, please explain in Comments below.

**Note: Manufacturers purchasing product labels or packaging for resale with a product are considered end users of special printing aids and should select either D or E even though the printed material is resold. (See the cover letter accompanying this form for more information.)**

- A. A special printing aid **was purchased for resale** and resold in a sale subject to California tax.
- B. The special printing aid **was purchased for resale** and resold to the US government.
- C. The special printing aid **was purchased for resale** and sold with a nontaxable sale of printed material other than US Government (ie. Interstate commerce, newspaper, printed sales message). **Our sale of the special printing aids was:**
  - C1. a sale for resale. We separately stated the sale price of the special printing aids and obtained a resale certificate for the special printing aids from our customer. The separately stated sales price was at least the amount of the sales price we paid for the special printing aids or their components.
  - C2. subject to tax. Tax was paid to the Board with our sales tax return. *Indicate amount of tax and period reported under Response above.*
  - C3. subject to tax. Tax was paid to the Board as a result of an audit that included the above purchases either on an actual basis or as a result of a percentage of error based upon a test. The purchases sampled in the audit were similar in nature to the above transaction; we believe tax on the above transaction has been paid to the Board as a result of the audit. *Indicate amount of tax and audit period under Response above.*
  - C4. subject to tax. However, we did not pay tax with our sales tax return or through an audit.
- D. The special printing aid **was not purchased for resale**. However, tax was paid directly to the Board with our sales tax return. *Indicate amount of tax and period reported under Response above.*
- E. The special printing aid **was not purchased for resale** and tax is applicable.

COMMENTS \_\_\_\_\_

NATURE OF BUSINESS \_\_\_\_\_

PURCHASER'S SALES TAX PERMIT NUMBER	PURCHASER'S NAME
SIGNATURE	TITLE
DATE	PHONE
	CITY

*The information provided above is subject to verification by the State Board of Equalization.*

**STATEMENT CONCERNING PROPERTY PURCHASED WITHOUT PAYMENT OF CALIFORNIA SALES TAX**

DMA \_\_\_\_\_  
Auditor's Initials \_\_\_\_\_

Please complete this inquiry statement to indicate the disposition of certain non-taxed purchases you made from the seller listed below. Please fill out the form completely, check the appropriate boxes, and sign as your company's authorized representative. The form should be returned within 10 days.

NAME OF SELLER FROM WHOM YOU PURCHASED ITEMS WITHOUT SALES TAX \_\_\_\_\_ SELLER'S PERMIT NO. \_\_\_\_\_

DATE	INVOICE NUMBER	PURCHASE ORDER NUMBER	AMOUNT	DESCRIPTION

Please check the appropriate boxes below. If none apply, please explain on the "Comments" line.

**Miscellaneous items purchased for resale**

- I have sold the property. I did not use it for any purpose other than resale inventory, demonstration, or display. It was for sale from the time I bought it until I sold it.
- I currently hold the property in my resale inventory. I have not used it for any purpose other than demonstration or display and it has been for sale at all times.

**Feed purchased to feed animals**

I purchased the feed listed above

- To feed animals I sell in my business or whose offspring I sell.
- To feed animals commonly used to produce food (meat, dairy products, eggs, etc.).

**Seed and plants purchased to plant or feed to animals**

- I purchased the seeds or plants listed above to grow products I will sell.
- I purchased the seed listed above to feed directly to, or to produce feed for, (1) animals I sell in my business, or (2) animals commonly used to produce food (meat, dairy products, eggs, etc.).

**Fertilizer**

- I purchased the fertilizer listed above for applying to land or plants to grow (1) feed for animals commonly used to produce food, (2) plant products I will sell in my business, or (3) food crops.

**Items purchased for your own use**

- I purchased the items listed above for my own use, not for resale, and
  - I paid tax to the Board of Equalization in the amount of \_\_\_\_\_ with my sales and use tax return for the reporting period \_\_\_\_\_.
  - Tax in the amount of \_\_\_\_\_ was added to the billing and paid to the seller listed above.
  - The purchase is a taxable transaction and no tax has been paid on it.

COMMENTS \_\_\_\_\_

NATURE OF BUSINESS \_\_\_\_\_

PURCHASER'S SALES TAX PERMIT NUMBER (If you are not required to hold a permit, please note.) \_\_\_\_\_ PURCHASER'S NAME \_\_\_\_\_

SIGNATURE \_\_\_\_\_ TITLE \_\_\_\_\_

DATE \_\_\_\_\_ PHONE \_\_\_\_\_ CITY \_\_\_\_\_

**STATEMENT CONCERNING PROPERTY PURCHASED WITHOUT PAYMENT OF CALIFORNIA SALES TAX**

DMA \_\_\_\_\_  
Auditor's Initials \_\_\_\_\_

Please complete this inquiry statement to indicate the disposition of certain non-taxed purchases you made from the seller listed below. Please fill out the form completely, check the appropriate boxes, and sign as your company's authorized representative. The form should be returned within 10 days.

NAME OF SELLER FROM WHOM YOU PURCHASED ITEMS WITHOUT SALES TAX				SELLER'S PERMIT NO.
DATE	INVOICE NUMBER	PURCHASE ORDER NUMBER	AMOUNT	DESCRIPTION

Please check the appropriate boxes below. If none of these apply, please explain below.

- The above property was purchased for resale and was resold in the form of tangible personal property. It was not used for any purpose other than retention, demonstration, or display while being held for sale in the regular course of business.
- The above property was purchased for resale and is presently in resale inventory. It has not been used for any purpose other than retention, demonstration, or display while being held for sale in the regular course of business.
- The above property was purchased for leasing and tax measured by rental receipts has been paid directly to the Board with our sales tax returns.
- The above property was purchased for resale to the United States Government. In accordance with the title provisions of the U.S. Government supply contract, the U.S. Government took title to the property prior to any use of the property by us.
- The above property was purchased for our own use and not for resale, and
  - tax in the amount of \_\_\_\_\_ was paid directly to the Board with our sales tax return for the reporting period
  - tax in the amount of \_\_\_\_\_ was added to the billing and remitted to the Seller.
  - the purchase is a taxable transaction and tax is applicable.

COMMENTS \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

NATURE OF BUSINESS		
PURCHASER'S SALES TAX PERMIT NUMBER		PURCHASER'S NAME
SIGNATURE		TITLE
DATE	PHONE	CITY

The information provided above is subject to verification by the State Board of Equalization.

**STATEMENT CONCERNING PROPERTY PURCHASED  
WITHOUT PAYMENT OF CALIFORNIA SALES TAX**

DMA \_\_\_\_\_  
Auditor's Initials \_\_\_\_\_

Please complete this inquiry statement to indicate the disposition of certain non-taxed purchases you made from the seller listed below. Please fill out the form completely, check the appropriate boxes, and sign as your company's authorized representative. The form should be returned within 10 days.

NAME OF SELLER FROM WHOM YOU PURCHASED ITEMS WITHOUT SALES TAX				SELLER'S PERMIT NO.
DATE	INVOICE NUMBER	PURCHASE ORDER NUMBER	AMOUNT	DESCRIPTION

Please check the appropriate boxes below. If none of these apply, please explain below.

- The above property was purchased for resale and was resold in the form of tangible personal property. It was not used for any purpose other than retention, demonstration, or display while being held for sale in the regular course of business.
- The above property was purchased for resale and is presently in resale inventory. It has not been used for any purpose other than retention, demonstration, or display while being held for sale in the regular course of business.
- The above property was purchased for leasing and tax measured by rental receipts has been paid directly to the Board with our sales tax returns.
- The above property was purchased for our own use and not for resale, and
  - tax in the amount of \_\_\_\_\_ was paid directly to the Board with our sales tax return for the reporting period \_\_\_\_\_.
  - tax in the amount of \_\_\_\_\_ was added to the billing and remitted to the Seller.
  - tax was paid directly to the Board as the result of an audit determination dated \_\_\_\_\_ covering the period \_\_\_\_\_ to \_\_\_\_\_. The Board's audit specifically included the above transaction in the audit assessment.
  - tax was paid directly to the Board as the result of an audit determination dated \_\_\_\_\_ covering the period \_\_\_\_\_ to \_\_\_\_\_. The Board's audit examined our purchases on a test basis with a percent of error computed and applied. Because the purchases sampled in the audit were similar in nature to the above transaction, we believe tax on the above transaction has been paid to the Board as a result of this audit.
  - the purchase is a taxable transaction and tax is applicable.

COMMENTS \_\_\_\_\_

NATURE OF BUSINESS		
PURCHASER'S SALES TAX PERMIT NUMBER		PURCHASER'S NAME
SIGNATURE		TITLE
DATE	PHONE	CITY

The information provided above is subject to verification by the State Board of Equalization.



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

[STREET ADDRESS]
[MAILING ADDRESS]
XXX-XXX-XXXX • FAX XXX-XXX-XXXX
www.boe.ca.gov

BETTY T. YEE
First District, San Francisco

BILL LEONARD
Second District, Ontario/Sacramento

MICHELLE STEEL
Third District, Rolling Hills Estates

JUDY CHU, Ph.D.
Fourth District, Los Angeles

JOHN CHIANG
State Controller

RAMON J. HIRSIG
Executive Director

[Purchaser's Name]
[Address]
[City, State, Zip]

[Salutation]:

The California State Board of Equalization would appreciate your assistance in verifying that untaxed sales made to you by [Business Name] were properly claimed as exempt sales in interstate commerce under the California Sales and Use Tax Law. Specifically, please verify: (1) that you purchased the item(s) listed on the enclosed Form BOE-52, Certificate of Verification, Out-of-State Delivery, and (2) the method of delivery. If these items were purchased by you, indicate the place of delivery and date you took possession of the item(s) on the enclosed certificate. If you did not purchase, take delivery or receive the item(s) in question, or if you took delivery in California, please check the applicable box on the certificate and provide us with your comments.

We ask that you complete and sign the certificate and return it, using the enclosed envelope, directly to the State Board of Equalization within 10 days of the date of this letter. Your prompt response in this matter is necessary for us to support any valid claims for exemption. Thank you for your cooperation.

Sincerely,

[Name]
[Title]

Enclosure:
BOE-52, Certificate of Verification, Out-of-State Delivery

State of California

Board of Equalization

## Memorandum

**To** : Chief, Field Operations Division  
Equalization Districts 1 and 2  
Out-of-State District (MIC 47), or

**Date:**

Chief, Field Operations Division  
Equalization Districts 3 and 4  
Centralized Collection Section (MIC 46)

**From** : District Administrator

**Subject** : Report of Suspected Money Laundering Activity

An <investigation/audit> of <taxpayer name, permit number> by <auditor/tax representative>, disclosed information which indicates possible money laundering activity as defined under various provisions of the Penal Code.

During the period from <mm/dd/yy> to <mm/dd/yy>, there were money transactions that appear unrelated to the normal business operations of a <type of business> with sales of money orders, travelers checks and/or check cashing operations.

The total amount of all transactions was <dollar amount>. The average transaction amount was <dollar amount>. Each transaction was made in the form of <cash, money orders, etc.>. A summary of these transactions is attached.

The detected activities took place at <business address> and funds were deposited in <list bank(s)> during the period from <mm/dd/yy> to <mm/dd/yy>.



**Audit Manual Chapter 5, Penalties**  
**Summary of Revisions**

**AM Section**

- AM 0501.22 Updates and classifies the list of penalties into mandatory penalties or discretionary penalties. Inserts a footnote for the operative date of RTC section 6597 (40% penalty).
- AM 0501.25 Updates procedures for review of requests for relief of mandatory penalties. Explains the type of request for relief handled by Headquarters sections.
- AM 0501.27 Adds procedures for processing relief of penalty reconsideration per Operations Memo 1133.
- AM 0502.35 Updates the list of legal Holidays.
- AM 0502.40 Identifies the Headquarters unit that handles requests for extension to file a return or pay the amount due. Inserts Form BOE-468, *Request for Extension of Time in which to File a Return*.
- AM 0503.05 Inserts the ten-year statute of limitation for eligible amnesty reporting periods (Operations Memo 1122, RTC section 7073(d)).
- AM 0503.10 Deletes "Definition of a Return" section since the subject is covered in the AM section that follows ("What Constitutes Filing a Return or Report").
- AM 0503.25 Deletes obsolete section (Unsigned No Remittance Returns). Unsigned returns are now acceptable pursuant to RTC section 6452 revised in 2000.
- AM 0503.30 Clarifies the application of securities and penalty for failure to file on closeout accounts. Deletes "Form BOE-414-A1" and inserts "Sales Tax Calculation Summary."
- Deletes Form BOE-10, *Field Determination*, as one of the forms that may be prepared when a delinquent return cannot be secured. This form is Fuel Taxes Division's form for jeopardy determinations.
- AM 0503.35 Explains the application of interest on erroneous refund pursuant to RTC section 6964.

- AM 0503.45 Deletes "Form BOE-414-A1" and inserts "Sales Tax Calculation Summary."
- AM 0504.10 Inserts a footnote to define "service" in the phrase "30 days after service of Notice of Determination."
- AM 0504.20 Explains that RTC section 6591 penalty applies if the amount due in a jeopardy determination is not paid within 10 days after service of notice and without a valid and timely petition.
- AM 0504.25 Inserts "Prepayment penalties are not assessed in sales and use tax audits."
- AM 0504.30 Clarifies application of electronic fund transfer (EFT) penalties.
- AM 0505.00 – 0505.10 Inserts new sections on amnesty penalties (Operations Memo 1122).
- AM 0506.20 Explains the application of the negligence penalty when an agent, employee, or partner of the taxpayer is guilty of negligence.
- AM 0506.35 Clarifies that when an evasion penalty is recommended a memorandum is required from the District Administrator to the Chief, Headquarters Operations Division.
- AM 0507.50 Explains that intentional destruction of records may be an indication of fraud or intent to evade the payment of tax.
- AM 0508.30 Explains that a taxpayer who does not qualify for RTC section 6596 relief may be relieved of the negligence penalty if the taxpayer contacted the Board about the proper application of tax and was misinformed by a Board staff.
- AM 0509.05 Inserts RTC section 6597 penalty (40 % for failure to remit tax collected).
- AM 0509.45 Clarifies the amount to which an evasion penalty may apply.
- AM 0509.50 Explains that sellers engaged in business at more than one location must hold a permit for each location, or subpermit for each location under a consolidated account. Clarifies

that RTC section 7155 penalty applies when the failure to obtain a permit is for the purpose of evading the payment of tax.

- AM 0509.55 Updates the guidelines for applying penalty for misuse of a resale certificate. Explains that the normal statute periods apply to RTC section 6094.5 penalty (Misuse of a resale certificate) – three years for taxpayers with permits and file returns; eight years for those who do not file returns; ten years for eligible amnesty reporting periods. Deletes second paragraph pertaining to seller’s acceptance of a resale certificate, which is irrelevant to the purchaser’s misuse of a resale certificate.
- AM 0509.65 Inserts new section “Failure to Remit Tax” (Operations Memo 1148) - penalty for failure to remit sales tax reimbursement or use tax collected, as imposed under RTC section 6597.
- AM 0509.68 Identifies penalties that may or may not be applied with RTC section 6597 penalty (Operations Memo 1148).
- AM 0509.70 Inserts the 10-year statute of limitations (RTC section 7073(d), Operations Memo 1122).
- AM 0509.75 Updates the procedures for recommending evasion penalty. Explains that criminal prosecution comments should be made only on the copy to the appropriate Chief, Field of Operations Division.
- AM 0510.20 Clarifies how penalties apply in bankruptcy cases. New text authored by Legal.

**Exhibits**

- Exhibits 1 & 2 Creates new exhibit to incorporate sample letters regarding the misuse of a resale certificate.
- Exhibit 3 Creates new exhibit to incorporate examples that illustrate the application of the 40% penalty (Operations Memo 1148).

The above summary includes substantive revisions only. However, all proposed revisions, including grammatical corrections, position title updates, and other minor changes are indicated in the attached material.

# PENALTIES

0500.00

## INTRODUCTION

0501.00

### BOARD POLICY ON PENALTIES

0501.05

It is the policy of the Board to encourage and assist all taxpayers in making an accurate and timely self-declaration of their tax liability. When that is done, there should be no occasion for imposition of penalties for negligence or fraud. The Board recognizes the many difficulties that taxpayers may be confronted with in attempting to comply with all requirements of the law. While unduly rigid or exacting requirements are not in the best interest of good tax administration, the Board does not condone carelessness or deliberate disregard by taxpayers of their obligations to keep accurate records and prepare proper returns. ~~However, when~~ When penalties are justified by the acts or omissions of the taxpayer, penalties should be applied properly and impartially. *Whenever there is any doubt as to whether factual conditions warrant a penalty for negligence or fraud, that doubt should be resolved in favor of the taxpayer.*

### RESPONSIBILITY OF FIELD AUDITORS FOR PENALTY RECOMMENDATIONS

0501.15

~~Most~~ Negligence and fraud penalties are generally imposed as a part of the determinations based upon field audit recommendations. Field auditors and their supervisors are responsible for making ~~sound~~ proper penalty recommendations based upon factual findings. This requires good judgment, common sense and a thorough understanding of the penalty provisions of the law.

A negligence penalty and a fraud penalty can never apply concurrently. The two penalties are mutually exclusive. The same is true of the penalty for negligence and the penalty for failure to file a return. However, a fraud penalty and a ~~10% percent~~ 10% percent penalty for failure to file may be ~~added~~ imposed to the same tax liability.

~~Whenever circumstances warrant the imposition of either a mandatory or a discretionary penalty, but not both, the mandatory penalty will apply. For example, the penalty for failure to file a return rather than the negligence penalty will apply in those cases where either penalty could be applied.~~

### DELINQUENCY PENALTIES

0501.20

~~For taxpayers not paying their taxes by EFT when they are required to do so, Section 6591 of the Sales and Use Tax Law imposes a 10% penalty for failure to pay tax timely. On and after January 1, 1997, this section also imposes a 10% penalty for failure to file a timely return. For taxpayers paying their taxes by EFT, as of January 1, 1999, Section 6479.3 includes all EFT related penalties. The penalties imposed under either of these sections are limited to a maximum of 10% of the amount of taxes, exclusive of prepayments, for the reporting period.~~

~~Returns are considered to cover the period which is indicated on them. For example, a taxpayer on a monthly basis does not report sales for May, but~~

~~instead includes these sales on his or her June return. The failure to file penalty would apply to May even though sales were subsequently reported in June.~~

~~Section 6476 imposes a 6 percent penalty on the amount of a prepayment that is paid late but which is paid before the last day of the monthly period following the quarterly period in which the prepayment was due.~~

~~Section 6477 imposes a penalty when a taxpayer fails to make a prepayment noted in the above paragraph but files before the last day of the monthly period following the quarterly period in which the prepayment became due, provided the taxpayer files a timely return and payment for the quarterly period in which the prepayment became due. The penalty is 6% of the amount equal to 90% of the tax liability for each of the periods during that quarterly period for which a required prepayment was not made.~~

~~The penalty imposed under section 6477 is increased by section 6478 to 10 percent if the failure to make the prepayment was due to negligence or intentional disregard of the Sales and Use Tax Law or authorized rules and regulations. Section 6478 also imposes a 10 percent penalty on the amount of any deficiency in the required prepayment if any part of that deficiency is the result of negligence or intentional disregard of the Sales and Use Tax Law or authorized rules and regulations. The penalties discussed in this paragraph are not applicable to amounts subject to a penalty under sections 6484, 6485, 6511, 6514, or 6591.~~

## **TYPES OF PENALTIES — OVERVIEW**

### **MANDATORY VS DISCRETIONARY PENALTIES**

0501.1022

~~The Sales and Use Tax Law sections covered by this audit manual provide for several penalties. There are penalties that are mandatory and imposed automatically, such as those imposed because payments are late, without regard to whether an audit is performed. There are others that are discretionary and may be assessed by auditors in the conduct of their audits. The main penalties that auditors may assess are summarized as follows:~~

~~\*10% of the tax due or \$500 whichever is greater~~

~~\*\*Plus any other applicable penalty~~

~~Numerous sections of the Revenue and Taxation Code (RTC) impose penalties. The Sales and Use Tax Law sections covered by this audit manual provide for several penalties. There Some are penalties that are mandatory and are imposed automatically, such as those imposed because payments are late, without regard to whether an audit is performed. There are others Other penalties that are discretionary and may be assessed by auditors in the conduct of their audits. (See AM 0203.21 for typical explanations of penalty recommendations in sales and use tax audits.) Examples of discretionary penalties include negligence, and fraud or intent to evade penalties. Whenever circumstances warrant the imposition of either a mandatory or a discretionary penalty, but not both, *the mandatory penalty will apply*. For example, the penalty for failure to file a return (mandatory penalty) rather than the negligence penalty (discretionary penalty) will be applied in those cases where either penalty could be applied is applicable.~~

**Mandatory Penalties**

<b>Nature of Penalty</b>	<b>Rate</b>	<b>RTC Sections</b>
Failure to file a return	10%	6511; 6591
Failure to pay taxes	10%	6565; 6591
Failure to pay prepayment amounts	6%	6476; 6477
Electronic Fund Transfer (EFT) related penalties exclusive of prepayments	10%	6479.3
Failure to pay prepayments by EFT	6%	6479.3
Amnesty interest penalty	50% <sup>a</sup>	7074
Double amnesty penalty	<sup>b</sup>	7073
Failure to pay prepayment amounts by suppliers and wholesalers of fuel	10% <sup>c</sup>	6480.4

<sup>a</sup> This penalty applies only to periods eligible for amnesty and is based on the unpaid tax as of March 31, 2005 (see AM sections 0505.00 – 0505.10 for more information).

<sup>b</sup> This penalty applies only to periods eligible for amnesty and is applicable to a Notice of Determination issued after April 1, 2005 (see AM sections 0505.00 – 0505.10 for more information).

<sup>c</sup> The rate of penalty is increased to 25% if the supplier or wholesaler knowingly or intentionally fails to make a timely remittance of the prepayment amounts.

**Discretionary Penalties**

Negligence or intentional disregard of the laws or authorized rules and regulations	10%	6478; 6484
Fraud or intent to evade the law or authorized rules and regulations	25%	6485; 6514
Improper use of a resale certificate for personal gain to evade the tax	<sup>d</sup>	6072; 6094.5
Failure to remit sales tax reimbursement or use tax collected	40% <sup>e</sup>	6597
Knowingly fails to not obtaining a valid permit in order to for the purpose of avoid-evading the payment of tax	50%	7155
Registration of a vehicle, vessel, or aircraft outside the of sState of California for the purpose of to-evading the payment of tax	50%	6485.1; 6514.1
Failure to obtain evidence that the operator of catering truck holds a valid seller's permit	\$500	6074
Failure of a retail florist to obtain a permit before engaging in or conducting -business as a seller	\$500 <sup>f</sup>	6077

<sup>d</sup> 10% of the tax due or \$500 whichever is greater.

<sup>e</sup> RTC section 6597 operative January 1, 2007.

<sup>f</sup> Plus any other applicable penalties.

The Board is empowered to relieve taxpayers of mandatory penalties for failure to file a timely return, payment, or prepayment when the Board determines that the failure to pay taxes or file a return timely was due to a reasonable cause and circumstances beyond the person's control, and such failure must have occurred notwithstanding the exercise of ordinary care and the absence of willful neglect. Taxpayers wishing to request relief from the payment of penalties should do so after issuance receipt of a determination. A request for relief must be presented in a written statement, under penalty of perjury, setting forth the facts upon which the request is based. The use of Form BOE-735, Request for Relief from Penalty (available at [www.boe.ca.gov](http://www.boe.ca.gov)), is recommended but not required.

Relief from penalties will be considered by the Board Members at their regular meetings. The following Headquarters sections evaluate requests for relief of mandatory penalties related to their respective areas of responsibility, and recommend either approval or denial of the request:

- Return Analysis Unit (MIC 35) – Late payment, late filing of returns, EFT penalty, etc.
- Petitions Section (MIC 38) – Determinations, audits, etc.
- Consumer Use Tax Section (MIC 37) – Vehicles, vessels, aircraft

Recommendation to approve or deny a request for relief above \$50,000 is forwarded to the Deputy Director for further review and then submitted to the Board Members for consideration.

## **PROCEDURES FOR RELIEF OF PENALTY RECONSIDERATION**

**0501.27**

Taxpayers may request reconsideration of denied requests for relief of mandatory penalties. Auditors should be aware of these procedures in order to respond to taxpayers' inquiries.

### **A. Penalties of \$50,000 or Less**

In the letter notifying the taxpayer of the Sales and Use Tax Department's (SUTD) recommendation to deny a request for relief of penalty, the Headquarters' section sending the letter (e.g., Return Analysis Unit) will add a statement explaining that the decision to recommend denying relief may be reconsidered if the taxpayer provides new information within 15 days. The letter will also explain that if the taxpayer provides additional information and the request for relief is still recommended for denial by the Headquarters' section, the request for relief will then be reviewed by the Deputy Director. If the Deputy Director agrees with the recommendation to deny the request for relief of penalty, the Deputy Director will send a letter to the taxpayer indicating that he or she agrees with the recommendation.

Staff should not regard the 15-day period as absolute – staff may still consider information received after 15 days. The 15-day period provides a reasonable deadline in which the taxpayer can respond.

### **B. Penalties in excess of \$50,000**

In the letter notifying the taxpayer of the SUTD's recommendation to deny the request for relief of penalty, the section sending the letter (e.g., Petitions

Section) will add a statement explaining that the decision to recommend denying relief may be reconsidered if the taxpayer provides new information within 15 days. The letter will also explain that if the taxpayer provides additional information and the request for relief is still recommended for denial by the Headquarters' section, the request will then be reviewed by the Deputy Director prior to placement on the Board calendar. If the Deputy Director agrees with the recommendation to deny the request for relief of penalty, the Deputy Director will send a letter notifying the taxpayer that the recommendation to deny the request for relief will be submitted to the Board Members. The letter will also include the anticipated date the Board Members will consider the request.

Again, the 15-day period is not absolute - staff may still consider information received after 15 days. The 15-day period provides a reasonable deadline so that penalty cases above \$50,000 may be timely placed on the Board calendar.

### **PENALTIES FOR NEGLIGENCE AND FRAUD**

**0501.30**

These penalties are imposed when there is "negligence or intentional disregard" or "fraud or intent to evade" the law or authorized rules and regulations, and may be asserted only as a part of determinations made by the Board ~~under the laws~~. Such penalties may be protested and are subject to cancellation if they ~~subsequently~~ are found to have been asserted in error.

~~On July 19, 1944, the Board ordered that w~~When a "fraud" or "intent to evade" penalty has been imposed (i.e., billed on a Notice of Determination), any change in such penalty shall be made only by the elected Board itself and not by Board staff.

### **PENALTIES IN BANKRUPTCY CASES**

**0501.35**

~~In bankruptcy cases, penalties are chargeable to the various parties involved, as indicated below. It will be noted that these instructions also apply to debtors in possession under Chapters X and XI of the Bankruptcy Act.~~

~~Section 507(a)(8) of the Bankruptcy Code does not permit a tax penalty to be filed as a priority claim against the bankrupt estate in regular bankruptcy proceedings. Accordingly, no penalties attaching under any of the provisions of the business tax laws can be included in the priority claim against the bankrupt estate in such proceedings. However, the penalties become the personal liability of the debtor, whether attaching before or after the date of the petition in bankruptcy, unless chargeable against a trustee, receiver or "debtor in possession" or unless corporate reorganization or arrangement proceedings are involved. Any appropriate penalties should be included when submitting Form BOE 414-A so that steps may be taken to collect such penalties under personal liability of the debtor after discharge.~~

### **RECEIVERS, TRUSTEES AND DEBTORS IN POSSESSION**

**0501.40**

~~Receivers or trustees of bankrupt estates and debtor in possession under Chapter X or XI are liable for penalties incurred while operating the bankrupt business. Accordingly, penalties which attach by reason of the delinquency or misfeasance of a receiver, trustee, or debtor while operating the bankrupt~~

~~business will be billed against such receiver, trustee, or debtor.~~

**~~NEGLIGENCE AND EVASION PENALTIES — DECEASED TAXPAYERS~~ 0501.45**

~~Negligence and evasion penalties will not be included in determinations made after the death of an individual taxpayer. It is obvious that the malleasant in such cases would not suffer the penalty, but the effect would be to reduce the assets for distribution to the estate of the deceased. However, such penalties are applicable to the negligence or evasion of the administrator(s) or executor(s) of the decedent's estate.~~

**~~NEGLIGENCE AND EVASION PENALTIES — DEATH OF PARTNER~~ 0501.50**

~~If a partnership is properly subject to a negligence or evasion penalty, that penalty will still be imposed even if the partnership is thereafter dissolved due to death of one of the partners.~~

**~~ASSIGNMENT FOR THE BENEFIT OF CREDITORS~~ 0501.55**

~~Any person who makes an assignment for the benefit of creditors and who owes an amount which became delinquent either before or after the assignment was made is charged with penalty and interest, when applicable, the same as other taxpayers.~~

**LOCAL AND TRANSACTIONS TAXES 0501.6035**

The penalty provisions of this chapter also apply to Uniform Local Sales and Use Taxes and Transactions (Sales) and Use Taxes. The penalties for negligence and evasion normally will apply to state, local, and transactions taxes. However, a recommendation for penalty may be restricted applied to state tax and not local tax, and or not transactions tax, or any combination, only one or two of the three taxes, as appropriate.

## DELINQUENCY PENALTIES SALES TAX RETURNS

0502.00

### WHEN PENALTY ATTACHES

0502.05

Delinquency penalty attaches if tax is not paid, as follows:

- a. ~~To self-declared tax, on or before the due date of the return or before the expiration of any extension that has been granted.~~
- b. ~~To determinations made by the Board, on or before the penalty date shown on the Notice of Determination unless a timely petition has been filed.~~
- c. ~~To redeterminations, on or before the penalty date shown on the Notice of Redetermination.~~

### **REPORTING BASIS**

0502.10

Sales tax returns are due on a calendar quarterly basis unless the Board has required or allowed the taxpayer to file returns on another reporting basis. A taxpayer cannot retroactively be placed on a reporting basis shorter (e.g., yearly to quarterly) than ~~its~~ the taxpayer's current reporting basis and become subject to a penalty for late payment because the due date for paying tax under the new reporting basis has already passed. Similarly, a taxpayer who has incurred a late payment penalty cannot avoid that penalty by being retroactively placed on a longer (e.g., quarterly to yearly) reporting basis.

### **DUE DATES OF RETURNS**

0502.15

Due dates for returns filed on the various reporting bases are as follows:

#### **Quarterly Basis**

Returns are due on or before the last day of the month following the close of the quarter. Taxpayers who make prepayments must also file the prepayment returns in accordance with RTC Section 6472.

#### **~~Odd~~ Irregular Quarterly Basis**

~~Where~~ For sales tax accounts that are on a 13-month year accounting cycle and are reporting quarterly over a period of 13 months, on a special basis which approximates that of the regular quarterly basis, such as a 13-month year, returns are due on or before the last day of the month following the close of the authorized reporting period.

#### **Monthly Basis**

Sales tax returns for each month are due on or before the last day of the following month.

#### **Yearly Basis**

Returns are due on or before the last day of the month following the close of the calendar year (reporting basis ~~Y~~) or fiscal year (reporting basis ~~F~~), except when the taxpayer closes out before the end of the year. (See AM Section 0502.30.)

When changing an account from a yearly or fiscal year basis to another basis, and the effective date is other than the beginning of the yearly reporting period, the district will furnish the taxpayer with a return to

report the expired portion of the year to and including the last day of the quarter which precedes the effective date of the new basis. The tax return for the expired portion of the year is due on or before the last day of the month following the effective date of the new basis.

## SALES TAX LIABILITY OF PURCHASERS

0502.20

A purchaser, as provided in RTC section 6421, who becomes liable for payment of sales tax ~~as if he or she were the purchaser~~ was a retailer making a retail sale ~~under Section 6421 of the Sales and Use Tax Law~~ has an obligation to file returns and is subject to the failure to file penalty provisions of ~~Sales and Use Tax Law~~ RTC Section 6511 if a return is not timely filed.

## CLOSEOUTS

0502.30

Except for taxpayers on an annual reporting basis, if a taxpayer sells a business or stock of goods or ~~quits~~ discontinues the business, a final return is not due until the due date of the return for the taxpayer's reporting period during which the closeout occurred. For a taxpayer on an annual reporting basis who ~~closes out the~~ discontinues a business, a closing return is due on or before the last day of the month following the close of the quarterly period in which the business was discontinued.

## EFFECT OF LEGAL HOLIDAYS AND WEEKENDS ON DUE DATES

0502.35

Whenever the due date ~~for the payment of the tax~~ falls on a Saturday, Sunday, or legal holiday, the filing of returns and the payment of taxes may be ~~paid~~ made on the following business day without penalty. The following is a list of legal holidays as set forth in the Government Code:

New Year's Day	January 1
Martin Luther King, Jr. Day	3 <sup>rd</sup> Monday in January
Lincoln's Birthday	February 12
President's Day	3 <sup>rd</sup> Monday in February
<u>Cesar Chavez Day</u>	<u>March 31</u>
Memorial Day	Last Monday in May
Independence Day	July 4
Labor Day	1 <sup>st</sup> Monday in September
Columbus Day	2 <sup>nd</sup> Monday in October
Veterans Day	November 11
Thanksgiving Day	4 <sup>th</sup> Thursday in November
Day <del>After</del> <u>after</u> Thanksgiving	<u>Friday after Thanksgiving</u>
Christmas	December 25

If one of the foregoing legal holidays falls on a Sunday, the following Monday is a legal holiday.

If Veteran's Day falls on a Saturday, the preceding Friday is a legal holiday.

## STATUTORY DATE FALLING ON SATURDAY, SUNDAY OR HOLIDAY

0502.36

Actions other than filing and paying returns, which must be timely, include:

1. Waiving the statute of limitations (RTC Section 6488)
2. Filing a petition for redetermination (RTC Sections 6538 & 6561)
3. Filing a claim for refund (RTC Section 6902)

4. Filing a suit for refund (RTC Sections 6933 & 6934)
5. Issuing a determination (RTC Section 6487)

The first four of these acts are permitted by taxpayers, and the last is a duty imposed on the Board. All of the acts are required by statute to be performed within a specified period of time.

When the due date of these acts falls on a Saturday, Sunday or holiday, it will nevertheless be timely if filed on the next business day that is not a legal holiday.

#### **PETITIONS FOR REDETERMINATION** 0502.45

~~A penalty is imposed on the amount of any determination made by the Board which is not paid on or before the date indicated on the notice, unless a petition is filed on or before that date. The rules for determining when a petition was filed are the same as those for determining when a payment was made.~~

~~In preparing a reaudit, the auditor should determine if the petition was timely. The taxpayer should be notified of any penalty to be added by headquarters because of a late protest or payment. Comments on the audit report should also indicate that a penalty will be added by headquarters.~~

#### **PAYMENTS OR PETITIONS MAILED BUT NOT RECEIVED** 0502.50

~~For purposes of determining whether a late payment or late filing penalty is applicable or a petition is filed timely, a payment or a petition alleged to have been placed in the mail will generally not be treated as received or filed timely unless it is actually received by the Board. Exceptions will be made in those instances where the taxpayer furnishes satisfactory proof that the original payment or petition was mailed timely.~~

#### **JEOPARDY DETERMINATIONS** 0502.55

~~Jeopardy determinations become final within 10 days after service of notice unless a petition is filed within such period and security is deposited in such amount as the Board may deem necessary. The Board will not recognize a petition in connection with a jeopardy determination unless such security is deposited with the Board on or before the date on which penalty attaches, in one or more of the following forms:~~

- ~~1. Cash deposits (personal checks not acceptable).~~
- ~~2. Certificates of deposit issued by banks.~~
- ~~3. Savings and loan certificates.~~

~~A document that purports to be a petition filed in connection with a jeopardy determination where security is not deposited is not a valid petition.~~

#### **EXTENSIONS FOR FILING RETURNS** 0502.6040

The various business tax laws (e.g., RTC section 6459) provide in part:

"The Board for good cause may extend, for not to exceed one month, the time for making any return or paying any amount required to be paid under this part. The extension may be granted at any time provided a request therefor is filed with the Board

within or prior to the period for which the extension may be granted.”

~~Extensions are granted by the appropriate headquarters unit only and must be requested by the taxpayer. Generally, the taxpayer requests the extension from the district office and the district office will submit a recommendation to the Return Analysis Unit (MIC 35) appropriate unit.~~ When an extension is granted for a specific period, a delinquency penalty will not apply if the tax is paid on or before the last day of the period for which the extension was granted. However, when an extension is granted, interest from the date on which tax would have been due must be paid. In cases in which an extension of time has been granted for making a prepayment, interest applies to the unpaid amount of the required prepayment.

Form BOE-468, *Request for Extension of Time in which to File a Return*, is available at the Board's website located at [www.boe.ca.gov](http://www.boe.ca.gov).

## ~~PENALTY FOR FAILURE TO FILE A RETURN~~

0503.00

### ~~WHEN PENALTY APPLIES~~

0503.05

~~Each taxpayer who has an active account under any of the revenue laws administered by the Board is required to file returns at regular intervals as prescribed by law and required by the Board. RTC section 6591 imposes a The 10% percent penalty for failure to file a return is imposed on the amount of taxes due, exclusive of prepayments, with respect to the period for which that return was required. (Also discussed in section 0501.20.) For example, if the taxpayer is on a monthly reporting basis, for example, and failed to file a return for only one month during a period under audit, a penalty would apply only to tax due for that month. Similarly, if a taxpayer on a monthly basis does not report sales for May, but instead includes these sales on his or her June return, the failure to file penalty would apply to May even though sales were subsequently reported in June.~~

~~Under RTC Ssection 6487, provides the statute of limitations on issuing determinations for failure to file a return. Under this section, a the determination for failure to file a return must be mailed within eight years after the last day of the calendar month following the quarterly period for which the amount is proposed to be determined. For eligible amnesty reporting periods, the determination may be issued within ten years from the due date of the tax (RTC section 7073(d)). Generally, the appropriate hHeadquarters unit determines whether a return has been filed for a given period at the time Form BOE-414 is prepared. Sales and Use Tax Law Section 6487 provides the statute of limitations on issuing determinations for failure to file a return. Under this section, a determination must be mailed within eight years after the last day of the calendar month following the quarterly period for which the amount is proposed to be determined.~~

~~The field auditor should be familiar with the following rules relating to this type of penalty:~~

### ~~DEFINITION OF A RETURN~~

0503.10

~~A return may be defined as a report filed with the Board by the taxpayer, in such form as may be prescribed by the Board, showing the amount of taxes due for the period covered.~~

### ~~WHAT CONSTITUTES FILING A RETURN OR REPORT~~

0503.15

~~A return is considered filed when the taxpayer provides in writing:~~

- ~~a. A request that the correspondence be accepted as a return or statement, regardless of how brief, indicating that the taxpayer is attempting to file a return.~~
- ~~b. The reporting period for which the correspondence (return) is filed.~~
- ~~c. The amount of tax due or that no tax is due.~~

~~When the taxpayer has shown due diligence in making every effort to submit what ~~he or she~~ the taxpayer feels is a return, the correspondence submitted should be accepted as a return. Even if the correspondence has no gross sales or deductions and shows only the net tax figure, it may be accepted as a return~~

if the information listed in a, b, and c above is provided. If a taxpayer's check indicates the reporting period and the measure of the tax being paid, it may be processed as a return. As a general rule, if tax due can be calculated from the information provided, the correspondence should be processed as a return. It is important to always consider the taxpayer's intent.

### **FORM BOE-401-E, NOT A RETURN FOR ALL PURPOSES**

0503.20

The filing of a Form BOE-401-E, *Consumers Use Tax Return*, cannot be regarded as the filing of a return with respect to sales tax liability as a seller, or use tax liability for sales made as a retailer, but only as the filing of a return with respect to use tax liability as a purchaser.

### **UNSIGNED NO-REMITTANCE RETURNS**

0503.25

When a document is received purporting to be a tax return, either on one of the forms prescribed by the Board or on some other form, which is not signed by the taxpayer and is not accompanied by a remittance, it will not be regarded as a return.

### **CLOSEOUTS WITH SECURITIES**

0503.30

Liquid securities (e.g., A cash deposit, certificate of deposit, or an insured deposit in a bank or savings and loan institution) ~~is~~ are considered to be an advance payment of any tax due on or after the date of closeout. This ~~s~~ Security will be applied in accordance with the guidelines discussed in the Compliance Policy and Procedures Manual (CPPM) (~~Section 400.000~~) Chapter 4, Security.

A negligence, fraud, or intent to evade penalty does not apply to a deficiency that is paid by the application of a liquid security where the due date of the closeout return is on or after the closeout date. This is because there was no amount required to be paid to which the penalty can be added. If the taxpayer is on a monthly basis, the quarter or quarters in which the closing month and the preceding month, ~~if involved,~~ occur should be segregated ~~on Form BOE-414-A~~ in the Sales Tax Calculation Summary in order to show clearly the application of ~~cash deposit~~ any liquid securities and penalties.

~~In contrast,~~ a penalty for failure to file will apply if a taxpayer submits a late return even though available when security exists ~~is available~~. Penalty for failure to file will also apply ~~Additionally,~~ even if when security is available to clear delinquent reporting periods ~~for closed-out accounts, the 10% failure to file penalty will apply.~~ A note is added on the billing to inform the taxpayer regarding of the type of penalty being applied.

When the security is not sufficient to meet the liability for the closing period, the procedure is as follows:

a. When a return was filed and an audit is in process —

~~Headquarters will issue a Form BOE 1210, Demand for Payment, or Form BOE 1210-1, Statement of Account, for the tax, interest, and penalty. Form BOE-414-A, Report of Field Audit, will not may recommend include a penalty because of failure to file but may recommend a penalty for negligence.~~

b. When no return was filed and an audit is in process —

Form BOE-414-A will include the penalty for failure to file for the amount of the taxes, exclusive of prepayments, with respect to the period for which ~~the a return is~~ was required.

A notation on Form BOE-414-A under "Special Instructions" should be made when a security is available. See AM Section 0204.12.

When an audit is not to be made, attempts should be made to secure signed returns for periods for which no returns were filed. When the delinquent return or returns cannot be secured, a Form BOE-414-B, Field Billing Order, or Form BOE-10, Field Determination, will be prepared to cover the estimated liability.

#### **ERRONEOUS REFUNDS OF ~~CASH~~ SECURITY DEPOSITS**

**0503.35**

If a ~~cash~~ security deposit available on the closeout date is erroneously refunded instead of being applied to a liability, no penalty or interest will be added to the amount which should have been paid from the cash deposit assessed where these charges would have accrued solely because of the erroneous refund. Interest will start to accrue if such liability is unpaid 30 days after the mailing of a notice of determination for repayment of the erroneous refund. In cases where ~~nothing is owing there was no liability~~ at the time the refund was made and a liability is later developed, ~~through an audit for example~~, applicable penalty and interest charge will be added.

#### **NO RETURNS FILED FOR PERIOD PRECEDING CLOSING PERIOD**

**0503.40**

There may be instances where no return was filed for the reporting period immediately preceding the closing period, and where the due date for the preceding period is after the date of closeout (e.g., the second quarter ~~1999~~2007, when closeout date was July 13, ~~1999~~2007). If any part of the ~~liquid~~ security deposit is applied to tax due for such periods, a negligence penalty will not attach to the amount of tax so paid. The ~~liquid~~ security deposit is considered available on the date of closeout. Therefore, to the extent that it is so applied, there is no amount required to be paid to the State to which penalty can be added. However, if a taxpayer fails to file a timely return for the preceding period, a failure to file penalty will apply to the amount of taxes, exclusive of prepayments, for this period that the return is required.

#### **TAXPAYERS ON A MONTHLY BASIS**

**0503.45**

In the case of taxpayers reporting on a monthly basis, where no return was filed for the closing month or the preceding month, the quarter or quarters in which such months occur should be broken down on ~~Form BOE-414-A~~ in the Sales Tax Calculation Summary, in order to show clearly the application of ~~liquid~~ security deposits and penalties.

#### **AVAILABILITY OF SECURITY BETWEEN BUSINESS TAXES**

**0503.5550**

All or the remainder of the security of a taxpayer's account may be transferred to another account of the same taxpayer. Information relative to the transfer is contained in the ~~Compliance Policy and Procedures Manual~~ CPM (Section 400.0000) Chapter 4, Security.

#### **MORE THAN ONE LOCATION**

**0503.6555**

Sellers engaged in business at more than one location must hold a permit for

each location, or a subpermit for each location under a consolidated account.

However, taxpayers who hold seller's permits for permanent places of business, and also conduct operations of a temporary nature at places such as fairs or carnivals, are not required to hold separate permits for the temporary operations. ~~They~~ Such taxpayers should report their sales made at the temporary location with the returns filed under their regular permit numbers. For multiple location permits, the temporary locations should be listed on Form BOE-530, "Schedule C — Detailed Allocation by Suboutlet of Uniform Local Sales and Use Tax." For single location permits, the temporary locations should be listed on Form BOE-530-B, "Local Tax Allocation for Temporary Sales Locations and Certain Auctioneers." The three-year limitation period applies, and the penalty for failure to file returns does not apply, with respect to any unreported sales tax liability incurred at the temporary location during any period for which a person has filed a return for a permanent place of business.

The three-year limitation period applies, and the penalty for failure to file returns does not apply, with respect to any unreported sales or use tax liability incurred in any period for which a person has filed a return for any location. This is true even though the person may operate at one or more other locations for which neither a permit nor a subpermit has been issued.

Where a taxpayer operating under a consolidated permit fails to include sales in his or her return relating to business at a particular location for which a subpermit is held, a penalty for failure to file a return does not apply, but the ~~ten~~ 10 percent penalty for negligence or the 25 percent penalty for fraud may apply if circumstances warrant.

**DELINQUENCY PENALTIES FAILURE TO PAY**

**05020504.00**

**WHEN PENALTY ATTACHES**

**05020504.05**

~~Delinquency penalty attaches~~RTC section 6591 imposes a 10 percent penalty for failure to pay tax timely if tax is not paid, as follows:

- a. To self-declared tax, when not paid on or before the due date of the return or before the expiration of any extension that has been granted.
- b. To determinations made by the Board, when not paid on or before the penalty date shown on the Notice of Determination unless a timely petition has been filed.
- c. To redeterminations, when not paid on or before the penalty date shown on the Notice of Redetermination.

The penalty for negligence and the penalty for failure to file cannot be imposed concurrently (AM section 0501.15).

**PETITIONS FOR REDETERMINATION**

**0502.450504.10**

~~Sales and Use Tax Law~~RTC section 6565 imposes a 10% percent penalty for failure to pay is imposed on the amount of any determination made by the Board which is not paid on or before the date the determination becomes final indicated on the notice (30 days after service<sup>1</sup> of notice of determination), unless a petition for redetermination is filed on or before that date. The rules for determining when a petition was filed are the same as those for determining when a payment was made.

In preparing a reaudit, the auditor should determine if the petition was timely. The taxpayer should be notified of any penalty to be added by ~~H~~Headquarters because of a late protest or late payment. Comments on the audit report should also indicate that a penalty will be added by ~~H~~Headquarters.

**PAYMENTS OR PETITIONS MAILED BUT NOT RECEIVED**

**0502.500504.15**

For purposes of determining whether a late payment or late filing penalty is applicable or a petition is filed timely, a payment or a petition alleged to have been placed in the mail will generally not be treated as received or filed timely unless it is actually received by the Board. Exceptions will be made in those instances where the taxpayer furnishes satisfactory proof that the original payment or petition was mailed timely.

**JEOPARDY DETERMINATIONS**

**0502.550504.20**

Jeopardy determinations become final within 10 days after service of notice unless a petition for redetermination is filed within such period and security is deposited within such period in such amount as the Board may deem necessary. The Board will not recognize a petition in connection with a jeopardy determination unless such security is deposited with the Board ~~on or~~ before the date on which penalty attaches, in one or more of the following

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<sup>1</sup> Date of mailing of the Notice of Determination or the date the Notice of Determination was delivered in person to the taxpayer.

forms:

1. Cash deposits, including cashier check and money order (personal checks not acceptable).
2. Certificates of deposit issued by banks.
3. Savings and loan certificates.

A document that purports to be a petition for redetermination filed in connection with a jeopardy determination where security is not deposited is not a valid petition. If the amount specified is not paid within 10 days after service of notice and without a valid and timely petition, a 10% percent penalty for failure to pay is imposed pursuant to RTC section 6591. A person against whom a jeopardy determination is made may nonetheless apply for an administrative hearing as provided by RTC section 6538.5.

### **PREPAYMENTS**

0504.25

RTC Ssection 6476 imposes a 6 percent penalty on the amount of a prepayment that is paid late but which is paid before the last day of the monthly period following the quarterly period in which the prepayment was due.

RTC Ssection 6477 imposes a penalty when a taxpayer fails to make a prepayment ~~noted in the above paragraph but files~~ before the last day of the monthly period following the quarterly period in which the prepayment became due, ~~provided the taxpayer files~~ but files a timely return and payment for the quarterly period in which the prepayment became due. The penalty is 6% percent of the amount equal to 90% percent of the tax liability for each of the periods during that quarterly period for which a required prepayment was not made.

The penalty imposed under RTC section 6477 is increased by RTC section 6478 to 10 percent if the failure to make the prepayment was due to negligence or intentional disregard of the Sales and Use Tax Law or authorized rules and regulations. RTC Ssection 6478 also imposes a 10 percent penalty on the amount of any deficiency in the required prepayment if any part of that deficiency is the result of negligence or intentional disregard of the Sales and Use Tax Law or authorized rules and regulations. The penalties discussed in this paragraph are not applicable to amounts subject to a penalty under RTC sections 6484, 6485, 6511, 6514, or 6591.

Prepayment penalties are not assessed in sales and use tax audits.

### **ELECTRONIC FUND TRANSFER RELATED PENALTIES**

0504.30

For taxpayers not paying their taxes by EFT when they are required to do so, Section 6591 of the Sales and Use Tax Law imposes a 10% penalty for failure to pay tax timely. On and after January 1, 1997, this section also imposes a 10% penalty for failure to file a timely return. For taxpayers paying their taxes by EFT, as of January 1, 1999, The penalties imposed in Sales and Use Tax Law RTC Ssections 6479.3 and 6591 includes apply all EFT related penalties to taxpayers who are required to pay taxes by means of Electronic Fund Transfer (EFT) and fail to do so. The penalties imposed under either of these RTC sections 6479.3 and 6591 are limited to a maximum of 10% percent of the amount of taxes, exclusive of prepayments, for the reporting period. Failure to

pay prepayments by electronic funds transfer is subject to a penalty of 6 percent of the prepayment amount incorrectly remitted (RTC section 6479.3 (e)(2).

## **AMNESTY PENALTIES**

**0505.00**

Beginning April 1, 2005, amnesty penalties may be applied to tax liabilities for reporting periods that began prior to January 1, 2003. See AM section 0206.52 for audit comments regarding the Amnesty Program.

## **50 PERCENT INTEREST PENALTY**

**0505.05**

### A. Application

The penalty is imposed pursuant to RTC section 7074 and applies to taxpayers who meet any of the following criteria:

- Qualified for amnesty but did not participate.
- Participated in amnesty but underreported their tax liabilities.
- Applied for amnesty but who did not enter into an Installment Payment Agreement (IPA) or pay their tax liability by May 31, 2005.

The penalty does not apply to:

- Tax liabilities for eligible tax reporting periods that were included in an IPA in place on January 31, 2005.
- Tax liabilities included in an amnesty IPA, even if the taxpayer subsequently defaults on its agreement.
- Tax liabilities for reporting periods not eligible for amnesty, for example, reporting periods for which a criminal court proceeding had been initiated against the taxpayer prior to amnesty.
- Eligible tax reporting periods where the tax portion of the liability was paid in full on or prior to March 31, 2005 (non-participant) or May 31, 2005 (participant).

### B. Computation

The penalty is equal to 50 percent of the interest on the unpaid tax amount remaining due as of March 31, 2005 (non-participants), or May 31, 2005 (participants who did not fulfill all program requirements), computed from the day following the original due date of the tax through March 31, 2005.

The penalty applies to both self-assessed and Board-assessed liabilities and is imposed beginning April 1, 2005 (non-participants) or June 1, 2005 (participants who did not fulfill all program requirements). With regard to Board-assessed liabilities, the penalty is imposed at the time the liability becomes final. Payment of the deficiency prior to the finality date does not prevent the penalty from applying.

## **DOUBLE PENALTIES**

**0505.10**

In addition to the 50 percent interest penalty, underreporters and nonreporters are subject to a penalty that doubles the rate of all penalties (except the 50 percent interest penalty) applicable to a Notice of Determination issued on or after April 1, 2005 (RTC section 7073). Additionally, if the finality penalty is imposed, it will be applied at double the normal rate.

## **NEGLIGENCE PENALTIES — GENERAL**

**05040506.00**

### **LEGAL BASIS**

**05040506.05**

The RTC sections relating to the negligence penalty contain the following language:

“If any part of the deficiency for which a deficiency determination is made is due to negligence or intentional disregard of this part or authorized rules and regulations, a penalty of 10 percent of the amount of the determinations shall be added thereto.”

### **DEFINITION**

**05040506.10**

Negligence may be defined in general as a failure to exercise due care. In most cases, the law has defined the exercise of due care as such care that a reasonable and prudent person would exercise under similar circumstances. With respect to business tax matters, negligence may be further defined as a substantial breach by the taxpayer of some duty imposed by the law or authorized rules and regulations.

### **NEGLIGENCE VS. INTENTIONAL DISREGARD**

**05040506.15**

There ~~may be~~ is a technical distinction between negligence and intentional disregard of the law or authorized rules and regulations in that intentional disregard implies something more than negligence. However, intentional disregard is less than fraud or ~~an~~ intent to evade the tax and is covered by the “negligence penalty.” Accordingly, the term “negligence penalty” will be used to include the penalty for negligence or for intentional disregard. If, however, a situation is encountered where the field auditor believes there is strong evidence of intentional disregard of the law or authorized rules and regulations, the audit report should include appropriate comments regarding the evidence of intentional disregard.

*Field auditors should not assume that a large audit deficiency or overpayment is indicative of either negligence or intentional disregard. ~~As stated in section 0101.20,~~ The auditor is ~~to~~ must use his or her highest skill and best judgment to determine whether the amount of tax has been reported correctly. This same judgment and skill ~~and judgment~~ should be used to determine whether a penalty should or should not be recommended. Refer to AM section 0101.20, Tax Audit Policies. ~~As detailed in section 0504.35,~~ The auditor must support a negligence penalty recommendation must be supported with by appropriate comments (refer to AM section 0206.45).*

### **ACTS OF AN AGENT, EMPLOYEE OR PARTNER**

**05040506.20**

In general, where an agent, employee, or partner of the taxpayer is guilty of negligence, with a resulting tax deficiency, the 10 percent penalty will apply. This is true even though the agent, employee, or partner acted without the taxpayer’s knowledge or consent, or acted contrary to the express instructions of the taxpayer. Situations may be encountered where the taxpayer has been defrauded by an agent, employee, or partner and as a result did not benefit from the understatement of tax. Whether the negligence penalty is imposed will depend upon whether circumstances made it difficult or impossible for the

taxpayer to detect such fraud. The application of a negligence penalty in these instances should be decided on a case to case basis.

### **CONDITIONS UNDER WHICH PENALTY APPLIES**

**05040506.25**

The negligence penalty applies only to deficiency determinations and it applies to the total amount of the tax ~~deficiency~~ liability. ~~In the normal field audit~~ Generally, this ~~will means~~ that, if the penalty applies, it will be for the entire period of the audit regardless of class of transactions involved. Before the penalty is ~~warranted~~ imposed, the following conditions must be present:

- a. A tax deficiency, and
- b. Evidence that any part of the tax deficiency is the result of negligence (or intentional disregard of the law or authorized rules and regulations).

### **IF PENALTIES APPLICABLE TO ONLY PART OF AUDIT PERIOD**

**05040506.30**

Situations may be encountered where the condition warranting the imposition of a negligence penalty is not present during the entire period under audit and where the imposition of the penalty to the entire amount of the tax ~~deficiency~~ liability would be inequitable. For example, a complete change of management occurred and conditions under one management were entirely different from those under the other. In these this type of situations, the auditor will prepare two sets of Form BOE-414-A or Form BOE-414-B, a full statement of the facts involved should be incorporated in the field audit report, and headquarters office will make two determinations, one for the period during which includes the 10 percent penalty should be included, and another for the other without the penalty period during which it should not be applied. Two Forms BOE 414 A will be required in such cases. Audit Determination and Refund Section will issue the Notice of Determination accordingly. The audit report with the penalty must include a full statement of the facts involved.

When considering the recommendation to impose a negligence penalty on a partial audit period, auditors should determine if the taxpayer made any effort during a subsequent period in the audit to correct the situation which led to negligence. If such an effort has been made, a penalty may not be appropriate.

### **PENALTY COMMENTS ON AUDIT REPORTS OR FBOSFIELD BILLING ORDERS**

**05040506.35**

~~Section 0206.03 states that "a~~ A comment should be made on any point area which will be of value in connection with making a determination" or in with "making a decisions respecting regarding future audits (AM section 0206.03)." Penalty recommendations are frequently a source of disagreement between staff and taxpayers. To ensure that both staff and taxpayers understand why a negligence penalty was or was not recommended, a penalty comment using the following guidelines must be made on in the back "General Audit Comments" section of the Form BOE-414-A or Form BOE-414-B. The sole exception is when the tax liability is less than \$2,500 and no penalty is recommended.

The factors which constitute negligence in keeping records (~~discussed in AM section 05057.00~~), negligence in preparing returns (~~discussed in AM section 05068.00~~), and evasion penalties (~~discussed in AM section 05079.00~~), must be carefully considered before determining whether a negligence or evasion penalty

should be imposed. If a negligence penalty is being recommended, the auditor must provide in clear and concise terms the rationale for imposing a penalty. An explanation of the evidence and facts upon which the auditor relies to support the recommendation for imposition of a penalty must be given. The explanation must enable supervisors, ~~and other reviewers, the taxpayer and/or taxpayer's representative~~ to determine whether the recommendation is consistent with the facts established by the audit. The comments must be factual, not merely the auditor's opinion, and must not be stated in a manner derogatory to the taxpayer or the taxpayer's employees. All penalty comments must be sufficiently clear to provide continuity information for that may be useful in subsequent audits of the taxpayer.

If the auditor believes the imposition of a penalty is inappropriate, he or she must use the same penalty comment guidelines as when recommending a negligence penalty. That is, the comments must be clear and concise; ~~they must~~ enable supervisors and other reviewers/~~readers of the audit working papers~~ to determine whether the recommendation is consistent with the facts established ~~by~~ in the audit, and ~~they must be sufficiently clear to provide continuity in the event of information that may be useful in a subsequent audit.~~ "Canned comments" such as "Negligence not noted;" "No negligence noted;" or "No penalty recommended," do not provide enough information and are **not** acceptable.

If an evasion (fraud) penalty is being recommended, the comment on the audit report must be ~~to the effect that include:~~ "Penalty pursuant to RTC Section 6485 of the Sales and Use Tax Law is recommended." ~~The details to support the recommendation will be included in the~~ In addition, a memorandum is required from the District Administrator to the Chief, Headquarters Operations Division by (see AM section 05079.75 for contents of this memo).

Field auditors are frequently faced with the decision of whether to recommend a penalty on the first audit of a taxpayer. This decision must be based on an objective evaluation of the audit findings and the taxpayer's background and experience. Generally, a penalty should not be recommended. However, there are circumstances where a penalty would be appropriate. Criteria that should be considered, among others, are the taxpayer's prior business experience, the nature and state of the records provided, and whether the taxpayer used an outside accountant or bookkeeper to compile and maintain the records, and/or to prepare the sales and use tax returns. ~~For example, a~~ penalty may be appropriate in any of the following circumstances: the taxpayer has no records of any kind, the taxpayer has a history of prior permits or business experience, analysis shows that purchases have exceeded reported sales, or the taxpayer has two sets of books. The comment "Taxpayer's first audit" should only be used in conjunction with a detailed explanation for the penalty recommendation.

To promote consistency in the application of penalties and the writing of penalty comments, all comments must be reviewed by the auditor's supervisor. In addition, special procedures will be used for the following reviews:

- **Audit tax deficiency over \$25,000** — Reviewed and approved by the auditor's supervisor.
- **Audit tax deficiency over \$50,000** — Reviewed and approved by the

District Principal Auditor ~~in addition~~ subsequent to the review and approval by the auditor's supervisor.

This review and approval must be noted by the supervisor (and DPA if applicable) by commenting and signing directly below the auditor's penalty comment ~~on~~ in the "General Audit Comments" section ~~back of the Form BOE-414-A or Form BOE-414-B.~~ This may be a handwritten comment or incorporated as the last line of the penalty comment (e.g., "Reviewed and approved. \_\_\_\_\_, Supervisor; \_\_\_\_\_, DPA.") See AM section 0206.45.

### **CLASSES OF NEGLIGENCE**

**05040506.45**

A taxpayer may be negligent in a number of ways, but there are only two kinds of negligence which will result in a tax deficiency and which may warrant the imposition of the negligence penalty. These are:

- a. Negligence in keeping records (AM sections 0507.00 - 0507.50, and
- b. Negligence in preparing returns (AM sections 0508.00 - 0508.50).

## **NEGLIGENCE IN KEEPING RECORDS**

**05050507.00**

### **GENERAL**

**05050507.05**

Guidelines for the maintenance of records are provided by Regulation 1698, *Records*. In general, this regulation provides that "a taxpayer shall maintain and make available for examination on request by the Board or its authorized representative, all records necessary to determine the correct tax liability under the Sales and Use Tax Law and records necessary for the proper completion of the sales and use tax return." Such records include:

- Normal books of account ordinarily maintained by the average prudent business person engaged in the activity in question.
- Bills, receipts, invoices, cash register tapes, or other documents of original entry supporting the entries in the books of account.
- Schedules or working papers used in connection with the preparation of tax returns.

Complete absence of records will constitute strong evidence of negligence. However, auditors should determine if there are mitigating circumstances for the lack of records (See AM section 05057.50). Where records are maintained and a tax deficiency results, various factors must be taken into consideration in determining whether the tax deficiency was due to negligence in keeping records. The term "records" as used herein includes not only those specifically mentioned in Regulation 1698, but also such supporting data as resale certificates, shipping documents in support of interstate transactions, etc.

### **TEST FOR NEGLIGENCE IN KEEPING RECORDS**

**05050507.10**

The primary test for negligence is whether a taxpayer keeps the type of records ordinarily maintained by a reasonable and prudent businessperson with a business of similar kind and size. If the evidence indicates that a taxpayer failed to keep such records and, as a result, failed to compile ~~his or her~~ tax returns with a reasonable degree of accuracy, and cannot substantiate the reported amounts when audited, negligence is indicated and the 10 percent penalty may be appropriate.

### **RECORDS NEED ONLY BE ADEQUATE FOR TAX PURPOSES**

**05050507.15**

Records need only be adequate for sales and use tax purposes. The fact that the records may not be adequate for the purpose of preparing balance sheets or profit and loss statements, or for furnishing accurate cost data, information to stockholders, creditors, or others interested in the business does not necessarily constitute negligence for sales and use tax purposes.

### **RECORDS NEED ONLY BE ADEQUATE FOR TYPE OF BUSINESS**

**05050507.20**

Records need only be adequate to meet the tax requirements of the type of business involved. For example, a small restaurant may require a very simple set of records for sales and use tax purposes, whereas, a large department store, oil company, automobile dealer, or contractor will require a much more complex accounting system.

### **NEGLIGENCE OF OTHER TAXPAYERS — NO EXCUSE**

**05050507.25**

A taxpayer should not be relieved of penalty for negligence in keeping records merely because there are many other taxpayers engaged in the same kind of business who also are negligent in keeping records. Each individual case should be decided on its own merits.

#### **EFFECT OF LACK OF KNOWLEDGE ON PART OF TAXPAYER**

**05050507.30**

A taxpayer should not be relieved of a penalty for negligence in keeping records merely because ~~he or she~~ the taxpayer is unaware of the requirements of the law. However, while lack of knowledge is no defense to the negligence penalty, a taxpayer of little education should not be expected to keep records in as good a form as a taxpayer who has wide knowledge of correct accounting principles. The taxpayer, ~~moreover,~~ cannot be regarded as negligent merely because ~~his or her~~ the records may be kept in a foreign language.

#### **ERRORS IN KEEPING RECORDS**

**05050507.35**

Where records are adequate for sales and use tax purposes but with numerous errors have been made which ~~that~~ result in understatements of understatement of tax, the test for negligence is whether or not the taxpayer exercised due care in keeping the records.

#### **ERRORS DO NOT NECESSARILY CONSTITUTE NEGLIGENCE**

**05050507.40**

No matter how carefully records are prepared and checked, some errors may occur. Accordingly, where errors are made in keeping records, the relative frequency and importance ~~thereof~~ of such errors must be considered before a taxpayer ~~may properly be~~ is regarded as negligent. Due consideration should be given to any particular accounting difficulties which ~~may be~~ are inherent in the taxpayer's business.

#### **CONSIDERATIONS IN CLASSIFYING ERRORS**

**05050507.45**

To determine whether errors constitute negligence, the following should be considered:

- a. The frequency of the errors relative to the volume of transactions. The number of errors found must be considered in relation to the total number and dollar amount of the same type of transaction in the audit period.
- b. The ratio of understatement to reported amounts. This percentage of error ratio may be used in a variety of ways. For mark-up audits, the most appropriate evaluation is the ratio of understatement to reported taxable measure, particularly when reported taxable sales have been impeached. For audits where taxable measure is based on a percentage of total sales or claimed deductions, the most appropriate evaluation is the measure of understatement to total reported sales or claimed deductions. For both ~~of these~~ methods, a large ratio of understatement may be indicative of negligence. If the audit measure is derived from a statistical sample, comparison of the error percentage in the prior audit may be appropriate if the same items are being sampled. A substantive increase or comparable error percentage may be indicative of negligence. However, it must be noted that a ratio of understatement is not, in and of itself, proof of negligence. A ratio should be considered in conjunction

with other factors to determine whether negligence has occurred.

- c. ~~The probable cause.~~ Auditors should consider the probable cause of errors found by audit. The cause of errors may result from procedural or operational problems unrelated to negligence. For example, significant changes in sales volume from a prior audit may cause errors that result from staffing problems rather than negligence. Similarly, a business with a large volume of small dollar transactions may find it infeasible to hire the level of staff that would result in the total elimination of errors.

If the errors are too frequent in relation to the volume of transactions, or if ~~they~~ the errors result in a higher ratio of understatement than would be expected of a reasonable and prudent businessperson engaged in a business of similar kind and size, or if there appears to have been an absence of due care, the 10 percent penalty should apply.

## **DESTRUCTION OF RECORDS**

**05050507.50**

All records pertaining to transactions involving sales or use tax liability must be preserved for a period of not less than four years unless the Board authorizes in writing their destruction within a lesser period.

Whether unauthorized destruction of records constitutes negligence depends on the circumstances in each case.

### **~~Where~~ Records Accidentally Destroyed**

When the taxpayer has exercised due care in preserving the records, ~~but and they records have been~~ were accidentally destroyed in spite of such care, the taxpayer cannot be said to have been negligent in failing to retain records. In reaching such a conclusion, the auditor should be satisfied that the records were actually destroyed, and that the destruction was accidental.

### **~~Where~~ Records Intentionally Destroyed**

Where records have been intentionally destroyed or destroyed as a result of negligence or lack of due care on the part of the taxpayer, any tax deficiency that is established will be presumed to have been the result of the taxpayer's negligence in destroying the records. The 10 percent penalty will apply unless there is evidence that the deficiency is not the result of the destruction of the records. Please note that intentional destruction of records may be an indication of fraud or intent to evade the payment of tax (AM sections 0509.00 - 0509.75).

## **NEGLIGENCE IN PREPARING RETURNS**

**05060508.00**

### **DEFICIENCY DUE TO MISUNDERSTANDING**

**05060508.05**

Where there is evidence that the tax deficiency resulted from a reasonable misunderstanding by the taxpayer concerning the application of the tax, no penalty will apply. However, where the taxpayer has been advised, as a result of a prior audit or by other means such as a specific letter, documented telephone call, or special industry notice, that the unreported items were subject to the tax, it is indicative of intentional disregard and a penalty may apply. The 10 percent penalty should not apply when there are mitigating circumstances such as an attempt on the part of the taxpayer to report the items, or changes in the taxpayer's type of business or business operations that affected reporting of the transactions in question.

### **TEST FOR NEGLIGENCE IN PREPARING RETURNS**

**05060508.10**

As in the case of negligence in keeping records, the test for negligence in preparing returns is whether the taxpayer failed to exercise ~~that the~~ degree of care ~~which would be exercised by the~~ an ordinary prudent businessperson who is engaged in a business of a similar kind and size, and who in good faith has attempted to prepare returns with a reasonable degree of accuracy.

### **MECHANICAL ERRORS**

**05060508.15**

Mechanical errors in compiling returns do not constitute negligence unless they ~~such errors~~ are sufficiently frequent or sufficiently large in amount to meet the test for negligence.

### **ERRORS IN APPLICATION OF LAW**

**05060508.20**

~~Errors in~~ Erroneous application of the Sales and Use Tax Law when completing returns does not constitute negligence unless there is evidence that the taxpayer failed to exercise due care in determining whether the transactions in question ~~were~~ are subject to tax. ~~This can be determined by ascertaining whether~~ The taxpayer may be regarded as having exercised due care if the taxpayer has acted in good faith and has made a reasonably diligent effort to ~~learn~~ determine how the tax applies to ~~his or her~~ the taxpayer's business. The average taxpayer is ~~neither a lawyer nor an accountant and~~ can only be expected to exercise the amount of diligence due from an ordinary prudent businessperson, ~~in his or her circumstances.~~

### **DUTY TO MAKE INQUIRY**

**05060508.25**

Where there is doubt concerning the correct application of the tax, the taxpayer has a duty to make an inquiry. If the taxpayer fails to make an inquiry, the 10 percent penalty may apply. In general, ~~if~~ the taxpayer does make an inquiry and fails to act upon the results of the inquiry, the 10 percent penalty ~~generally~~ should apply.

### **EFFECT OF ERRONEOUS INFORMATION**

**05060508.30**

If a taxpayer who was misinformed about the proper application of tax may be relieved from the payment of tax, interest and penalty if the taxpayer meets the requirements for relief under ~~was in doubt as to the application of the tax,~~

~~made an inquiry, was misinformed, and underreported tax based on that misinformation, RTC section 6596 (AM sections 0105.00 - 0105.10). If the taxpayer does not qualify for RTC section 6596 relief, the negligence penalty should not be imposed/warranted if the taxpayer provides evidence that the taxpayer contacted the Board to inquire about the proper application/reporting of tax and was misinformed by Board staff, was made in good faith to any of the following: However, the taxpayer remains liable for the applicable tax and interest.~~

- ~~a. The headquarters office.~~
- ~~b. The district office.~~
- ~~c. Any representative of the Board who is held out to the taxpayer as qualified and was authorized to give an opinion.~~

The taxpayer is required to furnish reasonable proof that the underreported tax was the result of erroneous information from the Board. In addition, the taxpayer should furnish a written statement of his or her interpretation of the information secured ~~from the above sources provided by the Board staff.~~

~~Relief from application of a negligence penalty is based on a finding that there was actually no negligence and it should not be confused with relief under section 6596. Relief under section 6596 includes relief from tax, interest, and penalty where there has been written advice by the Board in response to a request in writing from a specifically identified taxpayer who, in turn, described fully the specific facts and circumstances of the activity or transaction for which advice was requested. Approval of a section 6596 credit or adjustment has been delegated by the elected Board to the Deputy Director, Sales and Use Tax Department, or his or her designee.~~

#### **FAILURE TO REPORT PURCHASES SUBJECT TO USE TAX**

**05060508.35**

The same standards which determine the application of the negligence penalty to tax deficiencies arising from an understatement of gross receipts or an overstatement of claimed deductions are used to determine the application of the negligence penalty to a tax deficiency arising from failure to report purchases subject to use tax.

#### **MORE THAN ONE LOCATION**

**05060508.40**

A taxpayer operating under a consolidated permit who fails to include on returns sales relating to a location for which a subpermit is held may be presumed to be negligent for all tax due for that sublocation unless such omissions are infrequent and do not constitute a substantial part of the total deficiency.

#### **OTHER TYPES OF NEGLIGENCE**

**05060508.45**

While the ~~two foregoing~~ situations described in AM sections 0508.35 and 0508.40 are rather obvious classes of negligence in preparing returns, it is not intended that the imposition of the penalty for this reason be so limited, since many other types of situations will be encountered where items have been omitted from returns for no apparent reason except that taxpayer was negligent.

#### **WHERE WORKING PAPERS ARE DESTROYED**

**05060508.50**

~~Where~~ When the auditor finds that working papers used by the taxpayer in preparation of the tax returns have been destroyed and the taxpayer is unable to explain substantial deficiencies in reporting, taxpayer should be given a reasonable opportunity to prepare new working papers or to explain how amounts reported on returns were computed. Failure or inability on the part of the taxpayer to do so will ordinarily constitute evidence of negligence and warrant the imposition of the 10 percent penalty.

## EVASION PENALTIES

05070509.00

### GENERAL

05070509.05

In General, Penalties for fraud or intent to evade are imposed only in connection with deficiency determinations made by the Board. *It is important to remember that the Board has the burden of supporting the imposition of an evasion penalty.*

The RTC Ssections of the Sales and Use Tax Law dealing that impose with such evasion penalties are as follows:

- a. **RTC Ssections 6072 and 6094.5** — misuse of resale certificate to evade tax, 10% percent or \$500 whichever is greater.
- b. **RTC Ssection 6485** — fraud or intent to evade deficiency determination tax, 25% percent of determination.
- c. **RTC Ssections 6485.1 and 6514.1** — registration of a vehicle, vessel, or aircraft outside of this state for the purpose of evading tax, 50% percent of tax due.
- d. **RTC Ssection 6514** — fraud or intent to evade tax by failure to file return, 25% percent of tax, in addition to the mandatory **RTC Ssection 6511** failure to file penalty of 10% percent.
- e. **RTC section 6597** — failure to remit sales tax reimbursement or use tax collected. 40 percent of amounts representing sales tax reimbursement or use tax collected and not timely remitted to the Board.
- f. **RTC Ssection 7155** — failure to obtain valid permit by due date of first return for the purpose of evading tax, 50% percent of tax due before permit obtained.

### DEFINITION OF EVASION PENALTIES

05070509.10

Fraud may be defined as conduct intended to deprive the Sstate of tax legally due. An intent to evade may be defined as an intent to escape the payment of tax through deception or misrepresentation. Although there may be a legal distinction between fraud and an intent to evade, the terms will be considered synonymous in this manual, and penalties imposed as a result of such act will be referred to as evasion penalties.

### EVASION VS. NEGLIGENCE PENALTIES

05070509.15

Evasion is a step beyond negligence. When negligence penalties are recommended, the facts should indicate that the taxpayer failed to exercise due care in keeping records or preparing returns or intentionally ignored certain duties or requirements. The evasion penalties are to be applied if it can be shown that the taxpayer not only failed to fulfill certain duties, but such failure was intentional and for the purpose of evading part or all of the true tax liability.

### CONDITIONS WARRANTING AN EVASION PENALTY

05070509.20

Before an evasion penalty can be imposed, there must be clear and convincing evidence that an existing tax deficiency is the result of a deliberate intent to

evade the payment of tax. Where there is a substantial deficiency which cannot be explained satisfactorily as being due to an honest mistake or to negligence and where the only reasonable explanation is a willful attempt to evade the payment of tax, the ~~25% percent~~ evasion penalty should apply. The size of the deficiency in relation to the tax reported should be taken into account. The indication that a deficiency is due to intent to evade increases in direct proportion to the ratio of understatement when it cannot otherwise be satisfactorily explained.

## EVIDENCE OF EVASION

05070509.25

It is very difficult to secure direct evidence that a taxpayer intended to evade a tax liability. In most cases, it is necessary to rely on circumstantial evidence. ~~Certain acts-facts or actions are of such-by nature that they are evidence that a~~ of a deliberate attempt has been made to evade the payment of tax, and that an evasion penalty is warranted. ~~These commonly encountered include:~~ Such facts or actions include, but not limited to:

- a. Falsified records, especially when more than one set of records is maintained~~kept~~;
- b. Substantial discrepancies between recorded amounts and reported amounts which cannot be explained;
- c. Willful disregard of specific advice as to applicability of tax to certain transactions;
- d. Failure to follow the requirements of the law, knowledge of which requirements is evidenced by permits or licenses held by taxpayer in prior periods;
- e. Tax or tax reimbursement properly charged, evidencing a ~~knowledge of~~ the requirements of the law, but not reported;
- f. Transferring accumulated unreported tax from a tax accrual account to another income account.

Under the "clear and convincing" standard, any assertion of intent to evade the tax must be supported by as many of the above indicators as possible. These indicators of evasion must be documented. In addition to the findings of substantial discrepancies and proper charging of tax or tax reimbursement, other evidence of evasion must be included in the audit working papers. Such evidence can include copies of falsified records, Board letters providing specific advice, copies of previous permits and applications, and evidence of improper transfers of unreported tax. A summary of the evidence must be provided in the audit working papers. The summary must reference the schedules providing the evidence of evasion and must provide an explanation of how the evidence supports the recommendation for an evasion penalty.

## BURDEN OF PROOF

05070509.30

As a matter of law, fraud is never presumed but must be proven and the burden of proof is on the Board. However, the ~~burden-standard~~ of proof is not beyond a reasonable doubt as in a criminal prosecution. (See *Helvering v. Mitchell* (1938) 303 U.S. 391). Instead, the standard of proof in civil tax fraud cases is "clear and convincing evidence" (*In re Renovizor's Inc. v. BOE* (9th Cir. 2002) 282 F.3d 1233). "Clear and convincing evidence" requires evidence so

clear as to leave no substantial doubt as to the truth of an assertion of fraud. That is, there is a high probability that the assertion of fraud is true.

~~As noted in Sections 0507.20 and 0507.25, a~~ taxpayer's intent to evade the tax is the key element to proving fraud. The mere fact that a taxpayer has a substantial tax liability does not in and of itself prove intent. Rather the evidence must support intent. For example, a consistent pattern of underreporting may indicate evasion, particularly if there is no other explanation for the understatement. However, additional evidence ~~such as (e.g., falsified records)~~ must be provided to support fraud when the underreporting is random. In all cases where a fraud penalty is recommended, the district administrator must submit evidence of a substantial nature that the taxpayer knowingly committed specific acts with the intention of defrauding the State of tax, which was legally due. (See AM Ssection 05079.75.)

### **EVASION BY AGENT, PARTNER OR EMPLOYEE**

**05070509.40**

Auditors should recommend the 25 percent penalty when a taxpayer's agent, partner, or employee has acted with intent to evade tax payment, even though ~~such the~~ attempted evasion occurred without the taxpayer's knowledge or consent. This is because the fraud of the agent is imputed to the principal except when the principal taxpayer is defrauded by the agent or employee. For example, when tax has been understated to cover up money or property stolen from the taxpayer, such an evasion will not be imputed to the taxpayer and the penalty should not apply. Generally, if a taxpayer has not benefited from the intent to evade, the evasion penalty should not apply.

### **AMOUNT TO WHICH PENALTY APPLIES**

**05070509.45**

The evasion penalties under RTC sections 6485 and 6514 are imposed if any part of the deficiency is due to fraud or ~~an intent~~ intent to evade. Therefore the penalty will apply to the entire amount of the deficiency. In unusual cases ~~where it appears it may be inequitable to apply the penalty to an the entire deficiency because,~~ For example, a change in management during an audit period may have resulted in the discontinuance of fraudulent practices, or the reverse. In such cases, two field audit reports sets of Form BOE-414-A or Form BOE-414-B) should be submitted, one includes the penalty and the other without the penalty, accompanied by a full statement of the circumstances involved, and separate Forms BOE-414-A should be submitted. Headquarters will make two determinations accordingly, one with the penalty and one without.

Except for the penalties imposed under RTC sections 6485 and 6514, evasion penalties should be applied only to the portion of the deficiency which was the result of the act or acts that constituted evasion.

### **KNOWINGLY OPERATING WITHOUT A PERMIT**

**05070509.50**

Sellers engaged in business at more than one location must hold a permit for each location, or a subpermit for each location under a consolidated account.

RTC Ssection 7155 of the Sales and Use Tax Law imposes a 50% percent penalty of the tax due when a person, for the purpose of evading the payment of tax, knowingly fails to obtain a seller's permit. This penalty may be assessed

when all of the following factors are present:

1. The taxpayer did not obtain a permit prior to the date the first tax return was due.
2. The taxpayer, while operating without a permit, knew a permit was required.
3. The average **measure** of tax liability during the period in which the taxpayer operated without a permit was more than \$1,000 per month.

In addition, the Section 7155 penalty may apply when a person is engaged in business at more than one location but knowingly fails to obtain a permit or subpermit for each location.

### MISUSE OF A RESALE CERTIFICATE

05070509.55

~~RTC Section 6072 of the Sales and Use Tax Law imposes a penalty of 10% percent or \$500, whichever is greater, for each transaction where when a purchaser, knowingly issues a resale certificate while the person is not actively engaged in business as a seller, for personal gain or to evade the payment of the tax, knowingly issues a resale certificate while the person is not actively engaged in business as a seller. RTC Section 6094.5 of the Sales and Use Tax Law imposes the same penalty, 10% or \$500, whichever is greater, for each transaction where when the purchaser knowingly gives issues a resale certificate for personal gain or to evade the payment of the tax, for the property which he or she the purchaser knows at the time of the purchase will not be resold in the regular course of business. The normal statute periods apply to RTC section 6094.5 penalty - three years for taxpayers who have permits and file returns; eight years for taxpayers who do not file returns; ten years for eligible amnesty reporting periods (RTC section 7073 (d)).~~

~~When a resale certificate is accepted by a seller and it appears to meet all of the requirements of a valid resale certificate, it should be assumed the certificate was accepted in good faith. Unless there is other information that controverts this assumption, the seller should not be held liable for the tax. Instead, the purchaser who knowingly issued an improper certificate will be pursued for the tax and penalty. If, however, it is disclosed that the seller makes a practice of accepting defective resale certificates, the seller's good faith is in doubt. In this case, tax should be asserted against the seller and a dual determination issued against the purchaser for the tax and penalty.~~

~~The misuse of a resale certificate penalty generally applies in the following situations:~~

- ~~• The purchaser, who does not hold a seller's permit, issues a resale certificate with an erroneous seller's permit number or gives the valid number of a permit held by another person, or~~
- ~~• The purchaser's permit was closed out prior to the date of purchase, or~~
- ~~• The purchase, regardless of amount, is one of a series of purchases which were not intended to be resold by the taxpayer in the regular course of business, or~~

- The purchaser knowingly issued a resale certificate for personal gain or to evade the payment of the tax. In these cases, the penalty should normally be applied regardless of the amount of the purchase and whether or not the purchase is one of a series of intentional misuses of the purchaser's seller's permit privileges, or
- The purchaser has been advised either through prior audit(s) or other contact with Board staff on the proper use of resale certificates and/or the application of tax to purchases made for their own use.

The penalty generally does not apply in the following situations:

- The dollar amount of the purchase is very small, the purchase does not appear to be one of a series of intentional misuses of the seller's permit privileges by the purchaser, and there is no indication that the purchaser has knowingly issued a resale certificate for personal gain or to evade the payment of the tax, or
- The purchaser has purchased business supplies or similar items and it appears to be due to a misunderstanding of the law rather than an intentional misuse, or
- The item purchased has been reported on the purchaser's sales and use tax return(s).

It is the act of misusing a resale certificate, without regard to the amount, which warrants the imposition of the misuse of a resale certificate penalty. Therefore, the penalty applies in those instances where there is a pattern of intentional misuse by the purchaser, even though the amounts involved may be small. However, if the facts in question do not clearly support a finding that a resale certificate has been misused, then the penalty for misuse of a resale certificate does not apply.

In those instances where a number of small purchases from the same vendor are noted, a single, rather than multiple, penalty of \$500 or 10 percent (whichever is greater) generally applies unless the purchaser has been previously advised of the consequences of misusing a resale certificate.

If the misuse involves large amounts with the intent of evading the tax, the 25 percent fraud penalty under RTC section 6485 for intent to evade the tax should be considered if the evidence exists to support the imposition of the penalty.

Multiple \$500 penalties may be warranted in cases where there is an established pattern of misuse of resale certificates for material amounts with multiple vendors.

Exhibit 1 is a sample letter to be issued to a purchaser who is purchasing tangible personal property that is unusual for the type of business the purchaser is engaged in. If we are not requesting that the purchaser provide support for a specific transaction, we should make our intent clear. As this

letter is addressed to purchasers whom we suspect may be misusing a resale certificate, the tone must be explanatory.

Exhibit 2 is a sample letter that may be sent to purchasers when we have enough information to impose the misuse of a resale certificate penalty.

### **Investigations and Audits**

Leads regarding suspected misuses of resale certificates are to be treated as priority assignments. An auditor should investigate the purchaser to determine whether a misuse of a resale certificate has occurred. In those instances where the purchaser states that the merchandise was resold, the auditor must verify this statement by tracing the sale(s) to the taxpayer's sales invoice(s), sales journals, general ledgers, sales tax returns and/or other related books and records.

If the taxpayer states or the auditor's examination discloses that the merchandise was not resold, the auditor must expand the examination of the purchasers' records to determine whether other misuses have occurred. If misuse of a resale certificate is confirmed and the person is engaged in business, consideration should also be given to performing an audit of sales activity to ensure that all sales have been properly reported and exemptions properly claimed. Staff should close out accounts when the purchaser is not required to hold a permit.

The District Administrator will be responsible for approving recommendations to impose the misuse of a resale certificate penalty and whether or not prosecution should be sought. In every instance where the RTC section 6072 or 6094.5 penalty is recommended, Form BOE-414-A or Form BOE-414-B must be accompanied by a memorandum signed by the District Administrator, addressed to the Chief, Headquarters Operations Division (see AM section 0509.75). In addition to penalty comments, comments on whether prosecutions are recommended should be made on Form BOE-414-A or Form BOE-414-B.

### **OUT OF STATE REGISTRATION OF VEHICLE, VESSEL OR AIRCRAFT 05070509.60**

RTC Sections 6485.1 and 6514.1 provide a 50%—percent penalty on a purchaser who registers a vehicle, vessel, or aircraft outside of California (i.e., in another state or foreign country) for the purpose of evading the tax. The standards of proof for this penalty are similar to those for fraud in general.

The penalty under RTC sections 6485.1 and 6514.1 may not be asserted in conjunction with a penalty under RTC section 7155 (failure to obtain a permit) or section 6485 or 6514 (fraud or intent to evade). However, this penalty may be asserted in conjunction with penalties under RTC section 6511 (failure to file) or RTC section 6072 or 6094.5 (misuse of resale certificate).

The penalty will generally be applicable when the purchaser is a California resident who purchased a vehicle, vessel, or aircraft for use in California and ~~can~~ is unable to provide ~~no~~ convincing evidence for registration out of state, other than avoidance of the tax.

## FAILURE TO REMIT TAX

0509.65

For reporting periods beginning January 1, 2007, RTC section 6597 imposes a 40 percent penalty on any person who knowingly collects sales tax reimbursement (Regulation 1700, *Reimbursement for Sales Tax*<sup>2</sup>) or knowingly collects use tax, and fails to timely remit that sales tax reimbursement or use tax (tax) to the Board. The penalty is discretionary and may only be applied when all the conditions listed below are met:

1. The unremitted tax averages over \$1000 per month for the reporting period.
2. The total unremitted tax exceeds five percent of the total tax reported in the same quarterly reporting period in which the tax was due.
3. The taxpayer does not provide a credible explanation showing the failure to remit the tax was due to reasonable cause or circumstances beyond the taxpayer's control (see Regulation 1703(c)(3)(D)) and occurred notwithstanding the exercise of ordinary care and the absence of willful neglect.

See Exhibit 3 for examples that illustrate whether the 40 percent penalty applies.

The 40 percent penalty applies only to the unremitted tax established on an actual basis for the reporting periods where the taxpayer knowingly collected and failed to remit the tax. As with other evasion penalties, the application of the 40 percent penalty can extend the time for which determinations can be made beyond the otherwise applicable statute of limitations (AM section 0509.70).

When a taxpayer provides an explanation for failure to remit the tax, it will be the District Administrator's responsibility to determine whether there are sufficiently compelling reasons to justify the taxpayer's failure to remit the tax. Unless there is clear and convincing evidence that refutes the taxpayer's explanation for failing to remit the tax, staff should accept the explanation as meeting the taxpayer's burden of proof that their failure to timely remit the tax was due to reasonable cause and or circumstances beyond their control. If the penalty is not applied, the auditor must document the taxpayer's explanation on Form BOE-414-A, *Report of Field Audit* or Form BOE-414-B, *Field Billing Order*.

If the penalty is applied, the face of the audit report must include the notation "Penalty of 40% has been added for unremitted tax collected" and the "General Audit Comments" section must include a comment that the 40 percent penalty is recommended. Audit control staff will enter Line Item Number 23 on the Noncompliance screen and the code "UTC" (Unremitted Tax Collected) on the Principal and Interest screen.

When an audit recommends the 40 percent penalty, a memorandum is required from the District Administrator to the Chief, Headquarters Operations Division. See AM section 0509.75 for more information on this memo.

<sup>2</sup> Pursuant to R.C. S. 6109.0597, sales tax reimbursement also includes any sales tax that is advertised, held out, or stated to the public by any customer, director, or officer, that the tax or any part thereof will be assumed or absorbed by the retailer.

## MULTIPLE PENALTIES

05070509.6568

~~However, an auditor should not impose t~~Two or more fraud or evasion penalties may not be added against to the same deficiency determination when the penalties apply to the same series of acts or course of action in the same reporting periods.

- If a person with intent to evade tax fails to obtain a permit and fails to file a return, either ~~the SRTC section 7155 penalty (50% percent for failure to obtain a permit)~~ or RTC the Ssection 6514 penalty (25% percent for fraud or intent to evade tax by failure to file return) may be imposed, but not both.
- ~~The RTC Ssection 7155 penalty should not be applied in conjunction with a section 6485 penalty (25% percent for intent to evade).~~
- RTC section 6597 penalty (40 percent for knowingly collecting and failing to timely remit tax) should not be applied to liabilities for which a fraud or evasion penalty, or a negligence penalty has already been assessed in the same period.

~~However, U~~nder certain circumstances, more than one penalty may apply to the same determination:

- ~~The RTC Ssection 6511 penalty (10% percent for failure to file return) should be applied along with a RTC Ssection 6514 penalty (25% percent for fraud or intent to evade tax by failure to file return). A Section RTC section 6511 penalty may be applied with RTC a Ssection 7155 penalty (50% percent for failure to obtain a permit) #when appropriate.~~
- RTC section 6511 penalty may be applied in conjunction with RTC section 6597 penalty (40 percent for knowingly collecting and failing to timely remit tax).

The series of acts or course of action involved in the misuse of a resale certificate for the purpose of evading payment of tax on purchases are different from those involved in failing to obtain a permit for the purpose of evading the tax on **sales**. Therefore the following penalties may apply to the same determination:

- ~~A RTC section 6511 penalty (10% percent for failure to file a return) may be applied with a RTC section 6072 or 6094.5 penalty (improper use of resale certificate) since the RTC section 6511 penalty is not for fraud or intent to evade the tax. Similarly, the SRTC section 7155 penalty (50% percent for failure to obtain a permit) may be added to the same determination if appropriate.~~

## STATUTE OF LIMITATIONS FOR EVASION PENALTIES

05070509.70

The application of evasion penalties can extend determinations beyond the ~~otherwise applicable three or eight-year~~ statute of limitations set forth in RTC section 6487 or ten-year statute of limitations set forth in RTC section 7073 (d) (i.e., three or eight years). Therefore, tax can be assessed and penalties imposed for prior periods in which the taxpayer intentionally understated ~~his or her the~~ tax liability. However, proof that the taxpayer intentionally understated ~~his or her the~~ tax liability within the otherwise applicable statute of limitations (~~three, or eight or ten~~ years) is not by itself sufficient to support an evasion

penalty for periods **outside** the statutory period. Ideally, evasion should not be asserted for periods outside the applicable statutory period (three or eight years), unless records for the ~~outlawed~~expired periods are available, and such records they establish an actual tax liability, and support the assertion of fraud.

~~Where evasion was not disclosed in the audits have previously been made of prior periods but discovered in a subsequent audit, the prior periods will be included in the subsequent audit if the following conditions are met: and no evasion disclosed, such periods will not be included in subsequent audits even though evasion is discovered in periods covered by such subsequent audits unless there is a definite showing:~~

- ~~1. that e~~Evasion was present during the periods previously audited, and
- ~~2. that s~~Such evasion was not discovered at the time during the prior because audits because information necessary to its detection was concealed from the auditors who made the previous ~~audit,~~audit(s) or because of some other act(s) or fraud by the taxpayer.

### **APPROVAL OF EVASION PENALTIES**

**05070509.75**

~~In every instance where an evasion penalty is recommended, the audit report must be accompanied by a memorandum to the Program Planning Manager with an approval signed by the District Administrator. If the District Administrator is absent for an extended period the memorandum may be signed by the acting administrator. The memorandum must stand on its own and include in detail all of the facts and circumstances which are the basis for the evasion penalty recommendation. The facts and circumstances should be the same as those provided in the audit working papers and must cover any periods outside the statute of limitations. Any evidence that is not included in the audit working papers must be attached to the memorandum. If an audit includes related taxpayers, a separate memorandum must be prepared for each taxpayer on which the auditor recommends an evasion penalty. Approval to impose the evasion penalty will be obtained from the Program Planning Manager concurrently with the review process by the Centralized Review Section. After approval by the Program Planning Manager, the memorandum is returned to the district under a cover letter instructing the district to provide a copy of the approved memorandum to the taxpayer. A copy of the memorandum may not be provided to the taxpayer or a representative until it is approved by the Program Planning Manager.~~

When an audit recommends the evasion penalty, a memorandum is required from the District Administrator to the Chief, Headquarters Operations Division. Upon the approval of the District Administrator or someone acting on his or her behalf, and after the completion of district audit review, the memorandum along with the audit report and working papers will be forwarded to the Chief, Headquarters Operations Division for approval, with a copy of the memorandum to the Chief, Field Operations Division, Equalization Districts 1 & 2 and Out-of-State District, or the Chief, Field Operations Division, Equalization Districts 3 & 4 and Centralized Collection Section. The taxpayer may not be furnished a copy of the memorandum until the Chief, Headquarters Operations Division has approved the evasion penalty.

The memorandum must clearly state the evidence which supports the

taxpayer's intent to evade the payment of tax and must identify the elements or indicators of fraud applicable to the specific case. Any confidential evidence that is not included in the audit working papers must be attached to the memorandum. The memorandum must explain why the evasion penalty is appropriate versus the negligence penalty, and how the taxpayer benefited from the evasion. It must not include lengthy comments or comments that are already part of the audit verification comments. If the quarterly reconciliation of the audited and reported amounts supports the recommendation of the evasion penalty, such information should be summarized and not be shown on a quarterly basis. If an audit includes related taxpayers, a separate memorandum must be prepared for each taxpayer for whom the auditor recommends an evasion penalty.

In those cases where criminal tax evasion is suspected and potential prosecution is contemplated, the case should be referred to the Investigations Division through the Chief, Field Operations Division, Equalization Districts 1 & 2 and Out-of-State District, or Chief, Field Operations Division, Equalization Districts 3 & 4 and Centralized Collection Section. Criminal prosecution comments should be made only on the copy to the appropriate Chief, Field Operations Division.

## MISCELLANEOUS

05080510.00

### FAILURE TO OBTAIN EVIDENCE THAT OPERATOR OF CATERING TRUCK HOLDS VALID SELLER'S PERMIT 05080510.05

Any person making sales to an operator of a catering truck who has been required by the Board pursuant to RTC section 6074 of the Sales and Use Tax Law to obtain evidence that the operator is the holder of a valid seller's permit issued pursuant to RTC section 6067 of the Sales and Use Tax Law and who fails to comply with that requirement shall be liable for a penalty ~~of not to exceed~~ five hundred dollars (\$500) for each such failure to comply.

### FAILURE OF RETAIL FLORIST TO OBTAIN PERMIT 05080510.10

Any retail florist (including a mobile retail florist) who fails to obtain a seller's permit before engaging in or conducting business as a seller shall, in addition to any other applicable penalty, pay a penalty of five hundred dollars (\$500). For purposes of this regulation, "mobile retail florist" means any retail florist who does not sell from a structure or retail shop, including, but not limited to, a florist who sells from a vehicle, pushcart, wagon, or other portable method, or who sells at a swap meet, flea market, or similar transient location. The term "retail florist" does not include any flower or ornamental plant grower who sells his or her own products.

### PENALTIES IN BANKRUPTCY CASES 0501.350510.20

~~In bankruptcy cases, penalties are chargeable to the various parties involved, as indicated below. It will be noted that these instructions also apply to debtors in possession under Chapters X and XI of the Bankruptcy Act.~~

~~Section 507(a)(8) of the Bankruptcy Code does not permit a tax penalty to be filed as a priority claim against the bankrupt estate in regular bankruptcy proceedings. Accordingly, no penalties attaching under any of the provisions of the business tax laws can be included in the priority claim against the bankrupt estate in such proceedings. However, the penalties become the personal liability of the debtor, whether attaching before or after the date of the petition in bankruptcy, unless chargeable against a trustee, receiver or "debtor in possession" (or unless corporate reorganization or arrangement proceedings are involved. Any appropriate penalties should be included when submitting Form BOE 414-A so that steps may be taken to collect such penalties under personal liability of the debtor after discharge.~~

In bankruptcy cases, tax penalties for pre-bankruptcy periods should be determined in the same manner as for persons not in bankruptcy. Penalties are not entitled to the same priority treatment as pre-bankruptcy taxes and accrued interest. However, penalties maybe entitled to a distribution under a lesser priority. The Special Procedures Section will make an evaluation whether to include penalties in a proof of claim to be filed in a bankruptcy case. When a tax penalty is not discharged in a bankruptcy case, the penalties associated with the tax liability are likewise not discharged and any penalty should be included in the determination so it can be collected from the tax debtor.

The date the bankruptcy petition is filed must be noted in the audit. Pre-petition and post petition penalties should be separately identified.

**RECEIVERS, TRUSTEES AND DEBTORS IN POSSESSION**

**0501.400510.25**

Receivers or Trustees of bankruptcy estates and debtors in possession may under Chapter X or XI are liable for penalties incurred while operating the bankrupt business of a debtor. Accordingly, penalties which attach by reason of the delinquency or malfeasance of a receiver, trustee, or debtor in possession while operating the bankrupt a business will be billed against such receiver, to the trustee, or debtor in possession, and bankruptcy estate.

**NEGLIGENCE AND EVASION PENALTIES — DECEASED TAXPAYERS**

**0501.450510.30**

Negligence and evasion penalties will not be included in determinations made after the death of an individual taxpayer. It is obvious that the malfeasant in such cases would not suffer the penalty, but and the effect would be to reduce the assets for distribution to the estate of the deceased. However, such penalties are applicable to the negligence or evasion of the administrator(s) or executor(s) of the decedent's estate, or their intent to evade the payment of tax.

**NEGLIGENCE AND EVASION PENALTIES — DEATH OF PARTNER**

**0501.500510.35**

If a partnership is properly subject to a negligence or evasion penalty, that penalty will still be imposed even if the partnership is thereafter dissolved due to death of one of the partners.

**ASSIGNMENT FOR THE BENEFIT OF CREDITORS**

**0501.550510.40**

Any person who makes an assignment for the benefit of creditors and who owes an amount which became delinquent either before or after the assignment was made is charged with penalty and interest, when applicable, the same as other taxpayers.

SAMPLE WARNING LETTER – MISUSE OF A RESALE CERTIFICATE

EXHIBIT 1



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

www.boe.ca.gov

ABC Company  
One Main Street  
Sacramento, CA 95814

Date

In Reply Refer To:  
Account number

BETTY T. YEE  
First District, San Francisco

BILL LEONARD  
Second District, Ontario/Sacramento

MICHELLE STEEL  
Third District, Rolling Hills Estates

JUDY CHU, Ph.D.  
Fourth District, Los Angeles

JOHN CHIANG  
State Controller

RAMON J. HIRSIG  
Executive Director

Dear Mr. Jones:

The Board of Equalization has reviewed the records of one of your vendors and found resale certificates were issued by your company for items that do not appear to be of a type normally resold by your business. While the resale certificate may have been properly issued, in some cases businesses are not aware of the proper use of resale certificates.

The purpose of this letter is to remind you that resale certificates may only be issued for merchandise you intend to resell. Your seller's permit does not allow you to purchase property without tax for personal or business use. In fact, a purchaser who knowingly issues a resale certificate for the purpose of evading payment of the sales and use tax may be subject to one or more of the following penalties:

- *A penalty of \$500 or 10% of the amount of tax due, whichever is greater, for each misuse of a resale certificate.*
- *A 25% penalty for intent to evade the tax.*
- *Revocation of the seller's permit.*

At this time, we are not asking for any further information or action on any specific transactions.

If you have any further questions or concerns, please do not hesitate to contact us at the above address or call our Information Center at (800) 400-7115. You may also visit our website at [www.boe.ca.gov](http://www.boe.ca.gov).

Sincerely,



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

www.boe.ca.gov

BETTY T. YEE  
First District, San Francisco

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Second District, Ontario/Sacramento

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State Controller

RAMON J. HIRSIG  
Executive Director

Date

ABC Company  
One Main Street  
Sacramento, CA 95814

In Reply Refer To:  
Account Number

Dear Mr. Jones:

We have reviewed your response to our letter and the statement concerning "Property Purchased Without Payment of California Sales Tax." Based on the information you provided, it has been determined that a \$500 penalty for Misuse of a Resale Certificate is applicable. This penalty is in addition to the tax and interest on the same transaction.

The penalty for Misuse of a Resale Certificate is authorized pursuant to section 6094.5 of the Revenue and Taxation Code which states as follows:

*Any person, including any officer or employee of a corporation, who gives a resale certificate for property, which he or she knows at the time of purchase is not to be resold by him or her or the corporation in the regular course of business, is liable to the state for the amount of tax that would be due if he or she had not given such resale certificate. In addition to the tax, the person shall be liable to the state for a penalty of 10% of the tax or five hundred dollars (\$500), whichever is greater, for each purchase made for personal gain or to evade the payment of taxes.*

Please respond within the 10 days of the date of this letter if you do not agree with the imposition of any portion of this decision. I will consider any additional information that you provide before preparing my recommendation.

While there is no interest imposed upon penalties and interest, interest does continue to accrue on the amount of unpaid tax. For your convenience, I have enclosed Form BOE-1, *Audit Payment Information*. If you wish to make a payment toward any amount of tax, please return the bottom portion of the form with your payment and include the phrase "Misuse of Resale Certificate Billing" with your remittance so that we may properly credit your account.

If you have any further questions, please feel free to contact me at the telephone number or address shown above.

Sincerely,

Enclosure: BOE-1, *Audit Payment Information*

## Examples – Application of 40 Percent Penalty

Exhibit 3

The following examples illustrate whether the penalty is applicable.

### Example 1

During a quarterly reporting period, a taxpayer's total tax collected is \$10,000, as determined by an audit investigation. The taxpayer remits \$7,500 of the tax collected. The total unremitted tax is \$2,500. The average monthly unremitted tax is \$833 ( $\$2,500 \div 3$  months), which does not exceed \$1,000 per month. Since the average monthly unremitted tax is less than \$1,000 per month, the 40 percent penalty imposed pursuant to section 6597 does not apply.

### Example 2

During a quarterly reporting period, a taxpayer's total tax collected is \$500,000, as determined by an audit investigation. The taxpayer remits \$480,000 of the tax collected. The total unremitted tax is \$20,000. The average monthly unremitted tax is \$6,666 ( $\$20,000 \div 3$  months), which exceeds \$1,000 per month. However, five percent of the total amount of tax collected in the same quarter in which the tax was due is \$25,000 ( $\$500,000 \times .05$ ), which is more than the total unremitted tax of \$20,000. Since the unremitted tax amount (\$20,000) does not exceed 5 percent (\$25,000) of total tax reported in the same quarter in which the tax was due, the 40 percent penalty does not apply.

### Example 3

During a quarterly reporting period, a taxpayer collected \$22,000 in tax but remitted only \$10,000, as determined by an audit investigation. The total unremitted tax is \$12,000. The average monthly unremitted tax is \$4,000 ( $\$12,000 \div 3$  months), which exceeds \$1,000 per month, and five percent of the total tax collected in the same quarter in which the tax was due is \$1,100 ( $\$22,000 \times .05$ ). Since the average monthly unremitted tax (\$4,000) exceeds both the \$1,000 per month and the five percent of the total tax collected in the same quarter in which the tax was due (\$1,100), the 40 percent penalty may be applied to the \$12,000 liability, unless the failure to remit the tax when due was due to reasonable cause or circumstances beyond the person's control, (i.e., the Board lacks clear and convincing evidence that the person's otherwise reasonable explanation for failing to remit the tax is false).