

Audit Manual

Chapter 4

GENERAL AUDIT PROCEDURES



Sales and Use Tax Department

California State

Board of Equalization

This is an advisory publication providing direction to staff administering the Sales and Use Tax Law and Regulations. Although this material is revised periodically, the most current material may be contained in other resources including Operations Memoranda and Policy Memoranda.

Please contact any board office if there are concerns regarding any section of this publication.

Table of Contents

GENERAL AUDIT PROCEDURES	0400.00
INTRODUCTION	0401.00
General	0401.05
Objective of the Tax Audit	0401.10
Audit Selection	0401.15
Form BOE-1164 and Form BOE-1032	0401.20
Audit Memorandums Concerning State Agencies	0401.23
Authority — Examination of Records & Issuance of Subpoenas	0401.25
Public Relations	0401.30
Money Laundering	0401.35
TAX AUDITING	0402.00
Introduction	0402.05
Audit Approach	0402.10
Approach to Auditing Credits or Refunds	0402.20
Waiver of Credit Interest Policy	0402.25
PROGRAMMING — AUDIT SURVEY	0403.00
Starting an Assignment — General	0403.05
Preliminary Arrangements	0403.10
Discussion with Taxpayer	0403.12
Contacts with Third Party Representatives	0403.14
Limitations on Contacts with Taxpayers Represented by Counsel	0403.16
Written Correspondence	0403.18
Preliminary Examination	0403.20
Special Consideration — Fire or Natural Disaster	0403.23
Preliminary Testing	0403.25
Survey of Plant	0403.30
Receipt for Taxpayer's Records	0403.35
AUDIT PROGRAM — PROCEDURE TO FOLLOW	0404.00
Planning the Audit	0404.05
Audit Program	0404.10
Exploratory Testing	0404.15
MAKING THE AUDIT — PROCEDURES AND TECHNIQUES	0405.00
General	0405.05
Audits on a Taxable Measure Basis	0405.10
Short Tests	0405.15
Use of Test Basis	0405.20
Use of Form BOE-472, Audit Sampling Plan	0405.23
Bank Deposits	0405.25
Obtaining Financial Information	0405.27
Mark-Up Methods	0405.30
Use of Prior Audit Percentages of Error in Current Audits	0405.33
Cut-Off Techniques	0405.35
Whole Dollar Auditing	0405.40
Working Papers	0405.45

MAKING THE AUDIT —

APPLYING PROCEDURES AND TECHNIQUES..... 0406.00

General.....	0406.05
Examination of General Ledger Accounts	0406.10
Examination of General Journal	0406.15
Examination of Cash Receipts and Disbursements Records	0406.20
Examination of Accounts Receivable Ledger	0406.25
Examination of Purchase Journal.....	0406.30
Schedule of Total Sales or Revenue	0406.35
Gross Profit and Net Worth Analysis	0406.40
Mark-Up Based on Income Tax Returns.....	0406.45
Income Tax Returns as Basis of Audit.....	0406.50
Examination of Sales or Revenue Invoices.....	0406.55
Concessionaires	0406.60

SPECIALIZED TECHNIQUES — SALES AND USE TAX..... 0407.00

General.....	0407.05
Mark-Up Methods	0407.10
Short Tests.....	0407.15
Verification of Recorded Total Sales.....	0407.20
Cash Register Shortages	0407.25

PURCHASES SUBJECT TO SALES OR USE TAX 0408.00

General.....	0408.05
Methods of Verification	0408.10
Examination of Purchase Invoices	0408.15
Use of Form BOE-503, “ABC” Letter Procedure.....	0408.16
Assertion of Use Tax on Leases	0408.17
Use of Form BOE-1164, Audit Memorandum of Possible Tax Liability	0408.20
Use of Form BOE-1032, Information on Out-of-State Retailers	0408.22
California Use Tax Collections by Unregistered Out-of-State Retailers	0408.23
Examination of Selected General Ledger Accounts	0408.25
Other Records	0408.27
Capitalization of Resale Inventory	0408.28
Examinations of Journal Entries and Requisitions	0408.30
Fungible Goods	0408.35
Use or Loan of Property Purchased for Resale.....	0408.40

AUDIT OF SALES FOR RESALE 0409.00

General.....	0409.05
Methods of Reporting Resales	0409.10
Deduction Supported by Actual Lists.....	0409.15
Deduction Calculated	0409.20
Deduction Estimated	0409.28
Selection of the Basis for the Audit.....	0409.30
Detailed Audit — List of Claimed Resales Available.....	0409.35
Detailed Audit — List of Claimed Resales Not Available	0409.40
Effect of “Contra” Items on Deductions for Sales for Resale.....	0409.45

GENERAL AUDIT PROCEDURES

Acceptable Documentary Evidence	
to Support Sales for Resale.....	0409.50
Use of BOE-504 — XYZ Letter Procedure	0409.51
When Good Faith of Seller Is Questioned.....	0409.55
Purchase Orders and Resale Certificates	0409.60
Tax Assessed On Purchaser	0409.63
Tax Billed by Vendor But Deleted by Purchaser.....	0409.65
Verification of Payment of Use Tax by Purchaser.....	0409.70
Drop Shipments.....	0409.75
AUDIT OF SALES TO THE U. S. GOVERNMENT.....	0410.00
General.....	0410.05
Auditing Procedure	0410.10
Sales to Federal Employees Using U.S. Government Bankcards.....	0410.15
UNITED STATES GOVERNMENT SUPPLY CONTRACTS	0411.00
General.....	0411.05
Title Clauses.....	0411.10
Fixed Price Contracts	0411.15
Cost Reimbursement Contracts	0411.20
Leases.....	0411.25
AUDIT OF CASH DISCOUNTS	0412.00
General.....	0412.05
Actual Cash Discounts Taken on Taxable Sales	0412.10
Composite Percentage of Deductions Taken	0412.15
Percentage of Total Discounts Taken	0412.20
Trading Stamps	0412.25
Sales Promotion Plans	0412.30
Sales Tax Included In Cash Discounts	0412.35
AUDIT OF RETURNED MERCHANDISE.....	0413.00
General.....	0413.05
Methods of Claiming the Deduction.....	0413.10
Auditing Procedure — Deduction Claimed.....	0413.15
Auditing Procedure — Deduction Netted from Sales	0413.20
Rehandling and Restocking Charges.....	0413.25
Return of Tax Reimbursement.....	0413.26
Examination of Accounts Receivable	0413.30
Defective Merchandise.....	0413.35
Price Adjustments.....	0413.40
AUDITS OF SALES IN INTERSTATE OR FOREIGN COMMERCE	0414.00
General.....	0414.05
Auditing Procedure — Shipments Out-of-State.....	0414.10
Certificate of Verification — Out-of-State Delivery.....	0414.12
Audit Procedure — Shipments into the State	0414.15
AUDIT OF DEDUCTION FOR LABOR.....	0415.00
General.....	0415.05
Auditing Procedure	0415.10

AUDIT MANUAL

AUDIT OF SALES TAX INCLUDED IN SALES	0416.00
General.....	0416.05
Auditing Procedure	0416.10
TREATMENT OF EXCESS TAX REIMBURSEMENT	0417.00
General.....	0417.05
Refunds of Excess Tax Reimbursement.....	0417.07
Auditing Procedure	0417.10
Offsets	0417.15
Specific Applications.....	0417.20
AUDIT OF PRESCRIPTION MEDICINES.....	0418.00
General.....	0418.05
Auditing Procedure	0418.10
AUDIT OF OTHER DEDUCTIONS	0419.00
Audit of Bad Debt Deductions — General.....	0419.03
Auditing Procedure	0419.10
Special Situations	0419.15
Bad Debts Incurred by Lenders on Purchased Accounts Receivable	0419.17
Credit for Tax Paid to Other States, Section 6406 Credit	0419.20
Tax Paid Purchases Resold.....	0419.25
Audit of Charitable Organizations.....	0419.30
New or Remanufactured Trucks, Truck Tractors, Trailers, or Semitrailers.....	0419.45
Sales Tax Exemption for Foreign Diplomats.....	0419.50
Audit of Food Stamp Deduction.....	0419.60
Federal Excise Tax	0419.65
AUDIT OF LEASES	0420.00
General.....	0420.05
Auditing Procedure	0420.10
Timely Election	0420.15
Items Included in Rental Receipts	0420.20
Items Excluded from Rental Receipts	0420.25
Sale of Leased Property by Lessor	0420.30
Repair and Maintenance Contracts	0420.35
Fuel Used in Rental Vehicles “Wet Rentals”.....	0420.40
Audit of Sale and Leaseback Transactions	0420.45
Audit of Lease Transactions with Governmental Bodies	0420.50
AUDIT OF MOTOR VEHICLE FUEL	0430.00
General.....	0430.05
Auditing Procedure	0430.10
Methods of Verification	0430.15
Acquisition of Ex-Tax Gasoline.....	0430.20

GENERAL AUDIT PROCEDURES

AUDIT OF MOTOR VEHICLE FUEL RETAILERS —

PREPAYMENT OF SALES TAX 0431.00

General.....0431.05

Reporting Requirements.....0431.10

Auditing Procedures0431.15

Procedures Where Retailer is also a Supplier/Wholesaler.....0431.20

Local Tax Allocation0431.25

Bad Debts.....0431.30

Eligibility for Removal from Prepayment Status0431.35

Close-Outs.....0431.40

Working Papers0431.45

SPECIAL MOTOR VEHICLE FUEL TRANSACTIONS 0432.00

Retailers Who Premix or Blend Motor Vehicle Fuel and Lube Oil0432.10

Retailers Who Purchase Premix from a Supplier0432.15

Credit Card Sales0432.20

Master Contract Sales0432.25

Sales to the U.S. Government.....0432.30

Sales to Local Governments0432.35

Sales of Gasoline for Use in Aircraft.....0432.40

Sales to Aircraft Common Carriers and
Operators of Waterborne Vessels0432.45

Sales to Auto Leasing Firms.....0432.50

Sales to Lessors of Mobile Transportation Equipment0432.55

Refund of Sales Tax on State Motor Vehicle Fuel Tax Refunds0432.60

Refund of Sales Tax on Federal Excise Tax Refunds.....0432.65

AUDIT OF FUEL DISTRIBUTORS/BROKERS —

PREPAYMENT OF SALES TAX 0433.00

General.....0433.05

Prepayment Credits.....0433.10

Auditing Procedure0433.15

Reporting Errors0433.20

Audit Working Papers.....0433.25

Bad Debts.....0433.30

Local Tax Allocation0433.35

New Car Dealers0433.40

CREDIT OFFSETS..... 0434.00

Claim for Refund Filed While Audit Determination In
Petition Status or Within Six Months of Finality Date0434.05

Claim for Refund Filed When Audit Determination Not
in Petition Status or More Than Six Months
After Finality Date0434.10

Split Billings0434.15

Claim for Refund Filed Timely for Audit Determination
But not for Phone-In Determination0434.20

Application of Overpayments to Expired
Liabilities But Within the Claim for Refund Period0434.30

AUDIT MANUAL

MANAGED AUDIT PROGRAM	0435.00
Managed Audit Program – General	0435.05
Eligible Accounts	0435.10
Application of Interest and Penalties	0435.15
Audit Procedure.....	0435.20
GLOSSARY OF TERMS	0490.00

|

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 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 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 taxes correctly and efficiently. Interpretations of the law and related regulations during the audit process, provide taxpayers with proper basis or method for reporting future tax liabilities.

AUDIT SELECTION**0401.15**

Each district is responsible for determining which accounts are to be audited.

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 the auditor will prepare Form BOE-596, Report on Account Being Waived for Audit (AM section 0212.00).

When deciding whether to waive or perform an audit, 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. Such information should be communicated to the audit supervisor.

FORM BOE-1164 AND FORM BOE-1032**0401.20**

The auditor should prepare 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. 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.

Confidentiality of Form BOE-1164 and Form BOE-1032 Information. Current policy allows copies of Form BOE-1164 and Form BOE-1032 to be released to a taxpayer if the confidential information about another taxpayer is redacted. 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 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, or comments.

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, 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 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, 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 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.

AUDIT MANUAL

TAX AUDITING**0402.00****INTRODUCTION****0402.05**

Tax auditing is defined as an inquiry into all phases of a taxpayer's business in which significant tax error could occur. Tests are made in accordance with generally accepted auditing standards. They are extensive or comprehensive only to the degree necessary to support a professional audit opinion as to the correctness of returns as filed. Tests of records where potential errors are small are normally not as comprehensive as tests where substantial errors are possible. Expression of the auditor's opinion or recommendation concerning all tax-significant phases of a taxpayer's business are reflected in two types of audit reports. These are:

1. BOE-414-A "Change" reports recommending:
 - Deficiency determination per section 6481
 - Determination — No returns filed per section 6511
 - Refund recommendation per section 6901
2. BOE-414-C "No change" reports

Very limited testing or sampling may be all that is necessary to support a "No Change" report or "No Change" phase(s) of a "Change" report. Testing to support substantial change recommendations must include sufficient verification or explanatory comments so that the report is understandable and can be evaluated by other members of the staff as to the soundness of the auditor's opinion or recommendation. (See Chapter 2 for investigations (BOE-414-B) and field waivers (BOE-596) which are short of a full report as contemplated by BOE-414-C or BOE-414-A reports.)

Auditors should make the most efficient use of their time by making full use of all available records and worksheets of the taxpayer. The auditor should schedule exceptions noted. This has the advantage of aiding the auditor in discussing the direct findings with the taxpayer. This procedure also helps to clarify the auditor's thinking so that they may relate the exceptions to the specific law and/or regulations.

AUDIT APPROACH**0402.10**

Many taxpayers are careful to report taxable transactions accurately, especially after one or more audits have been made. To make an extensive examination of three years' operations in these situations may not be justified. Short tests should be made before starting a complete verification of three years' operations.

If these short tests indicate the taxpayer has not properly reported their tax liability, the auditor should make more extensive tests. The short test should be designed so that the result can be combined with more extensive tests to determine the proper measure of additional tax.

APPROACH TO AUDITING CREDITS OR REFUNDS**0402.20**

A primary purpose of the Board's audit program is to provide reasonable assurance that taxpayers pay neither more nor less tax than required by law. Consequently, the Board is just as concerned with refunding overpayments as with collecting underpayments. If a refund situation is noted in the course of the audit, the auditor should normally secure a claim for refund from the taxpayer utilizing the BOE-101, "Claim for Refund or Credit."

Sampling and projection techniques may be used by taxpayers to determine the amount of overpayment of tax liability using criteria similar to the techniques used by auditors (AM sections 0405.20 and 1302.05). If sampling and projection techniques are not appropriate for some or all of the transactions, the amount of the refund will be determined on an actual basis.

The preferred method of sampling is statistical sampling, as described in Chapter 13 of this manual. Claims for refund using statistical sampling methods must meet the Board's established standards for statistical sample evaluation.

If statistical sampling is not feasible, non-statistical sampling procedures, as discussed in this chapter, may be considered.

Once the taxpayer has filed a claim for refund and has requested or suggested determining the amount of refund by means of sampling, the claim will be assigned to an auditor who will contact the taxpayer to determine if sampling is feasible and, if so, develop a mutually agreeable sampling plan. The auditor may choose to consult a Computer Audit Specialist (CAS) on the sampling plan. Taxpayer requests for CAS consultation are subject to the procedures outlined in AM section 1302.25(h).

During the course of an audit, either conducted on an actual or sample basis, the auditor may detect both underpayments and overpayments. It is very important that the underpayments and overpayments (credit offsets) be treated equally. When an audit is done on a sample basis, both overpayments (in certain situations) and underpayments need to be taken into account and treated the same when examining sample items, analyzing the sample results, and projecting the resulting errors to the population being tested. Any allowable credit offsets resulting from the sample should be a part of the calculation of the percentage of error to be applied to the population. See section 1302.25(i) for additional discussion of tax overpayments (credit offsets) in the sampling plan.

The completion and transmittal of audit reports recommending refunds must be given urgent priority. Each district must establish permanent procedures for the early identification and control of audits involving refunds so that such audits are completed and transmitted without unnecessary delay.

WAIVER OF CREDIT INTEREST POLICY**0402.25**

Claims for Refund. The taxpayer should always be allowed a reasonable time in which to support a claim for refund. Under most circumstances, ninety days is considered reasonable.

If the taxpayer has been granted a ninety-day delay and requests additional time, consideration should be given to obtaining a waiver of credit interest. The Board may require a claimant to sign a Form BOE-146, Waiver of Credit Interest, as a condition to deferring action on a claim for refund (Revenue and Taxation Code section 6908(b)). In some cases, it may be appropriate to allow up to an additional ninety days because of the size of the claim and large amount of supporting detail required. However, delays beyond six months should not be allowed without a waiver of credit interest or the approval of the Deputy Director, Sales and Use Tax Department, or designee.

An extension of time beyond twelve months from the date the taxpayer was first notified in writing to compile the necessary data in support of the claim should not be allowed even if the taxpayer is willing to sign a waiver of credit interest or an extension to an existing waiver of credit interest. If the taxpayer does not provide the supporting data within the twelve-month period, the claim for refund will be denied for failure to support the grounds upon which the claim was based. Exceptions to this policy must be approved by the Deputy Director, Sales and Use Tax Department, or designee.

Deficiency Audits with Credits. If the taxpayer contends that there are other credits which offset or exceed a deficiency disclosed by an audit in process and requests a delay to obtain information supporting such credits, completion of the audit may be delayed for up to ninety days. A notation should be made on the BOE-414-Z of the date and reason for the delay. Should the taxpayer request a further delay, the deficiency audit should be completed as a non-concurred audit and processed in the usual manner.

With regard to the credits in question, it is critical that the auditor obtain a timely claim for refund which includes the taxpayer's specific contentions. The claim for refund, and when appropriate a waiver of credit interest, should be forwarded to the Audit Determination and Refund Section with all pertinent information concerning the credits and the waiver of credit interest. Subsequent action by the district office, if any, will be requested by Headquarters.

It should be noted that refunds are to be considered priority assignments. In those cases where a taxpayer has given the Board a waiver, it becomes even more imperative that prompt action be taken.

Authorized Signatory. To preclude any question about the validity of a waiver, the Form BOE-146, Waiver of Credit Interest, must be signed by (1) the taxpayer in the case of a sole proprietorship, (2) a partner in the case of a partnership, (3) a corporate officer in the case of a corporation, or (4) someone holding a written power of attorney from one of those persons.

The essential elements of a valid written power of attorney are:

1. The document must be dated and identified as a “power of attorney.”
2. The document must clearly authorize the agent (controller, assistant controller, or some other person) to act in a manner consistent with the signing of a waiver. Ideally, the power of attorney will authorize the agent to act in “sales and use tax matters.” However, a less specific description may be acceptable if it can reasonably be interpreted to impose upon the agent the right to execute the Form BOE-146, Waiver of Credit Interest.
3. The person granting the power of attorney must be the owner, partner, or a corporate officer of the company being audited.

With respect to corporations, if the title of the person signing the waiver is other than chairman of the board, president, secretary, or chief financial officer, the auditor must verify, by examining the corporate articles or bylaws regarding corporate officers, that the titled position constitutes a corporate officer.

With respect to partnerships, if the person signing the waiver is not listed as a partner on the IRIS TAR AI screen, the auditor will verify the validity of the person’s status as a partner by reviewing the partnership agreement. Any changes in partners must be reported to district compliance as provided in section 0219.03.

A copy of the written power of attorney must be obtained and attached to the copy of the waiver(s), Form BOE-146, and transmitted to Headquarters with the audit report if the waiver signatory is other than a corporate officer, partner or owner.

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**

The following procedures must be performed before starting an audit assignment:

- (a) Review the district master file (if available) to obtain information about the taxpayer's type of business, starting date, closeout date, ownership, reorganizations, and general record of reporting; and to review refund notices, delinquencies, audit memos, etc. The following taxpayer information may also be obtained through 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:

- Obtaining the date when the change or error first occurred.
- Notifying District Compliance as described in 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.

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

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 mail using Form BOE–80–A, *Audit Engagement Letter — Confirm Start Date*, with the enclosures listed above. If the audit will commence within a week of making the appointment, the engagement letter and enclosures 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 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 start of an audit, but should be alert to detect attempts to forestall it. If excessive delay in the start date is agreed to, and a reporting period is about to expire, Form BOE–80–B, *Audit Engagement Letter – Agreement to Delay Start Date* should be used. Form BOE–122, Waiver of Limitation, covering a minimum of two quarterly reporting periods 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, Form BOE–146, *Waiver of Credit Interest*, should be obtained.

If the auditor is unable to contact the taxpayer by telephone, Form BOE-80-C, *Audit Engagement Letter – Initiate Contact* should be used. If the taxpayer does not respond by the date specified on Form BOE-80-C, Form BOE-80-D, *Audit Engagement Letter – 10-Day Follow Up* should be sent to the taxpayer. As Form BOE-80-D explains, if the books and records are not provided by a specific date, the Board will either issue a subpoena requiring the taxpayer to provide the books and records or prepare a billing for estimated additional taxes due. 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 computerized records exist 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 RTC 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.

Comments regarding contacts and attempts to contact taxpayers, both oral and written, must be documented on Form BOE-414-Z, *Assignment Contact History*. Copies of correspondence referenced on Form BOE-414-Z should be included as a memo schedule with the AWP's. It should be noted in the "books and records" comment of the Field Audit Report or Field Billing Order if any records were withheld or were not available. *The auditor's comments must clearly state the effect the lack of records had on the amount 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. 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 the 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 taxpayer's representative concerning the 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 continue to contact the taxpayer but only after consulting with his or her supervisor. Such action should be based, in part, on the representative's degree of cooperation with the auditor and the fact that the taxpayer does not timely comply with the Board action requested through the representative.

If the taxpayer or 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 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, 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 auditor should confirm in writing any significant verbal contact or agreements with the taxpayer or 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.

PRELIMINARY EXAMINATION**0403.20**

This is the point at which the auditor takes “inventory” of all potential information sources. Unless the method used in reporting is entirely erroneous, audit time will ordinarily be saved by adapting the audit procedures to the taxpayer’s reporting methods. The auditor should ask the taxpayer to produce the desired records. These may be:

- General Ledger
- General Journal
- Sales Journal or Revenue Journal
- Purchase Journal
- Duplicate returns and working papers supporting them
- One or more months original documents, e.g., sales invoices, and purchase invoices

In addition to the above listed records, the auditor should question the taxpayer relating to such specifics as:

- Internal controls
- Systems in use
- Summary records, etc. (Including income tax returns)

If such preliminary examination of records indicates that substantial portions of the necessary documentation are not available (such as resale certificates), the auditor should advise the taxpayer what further data is needed and postpone starting the audit until this information has been obtained. Consideration should be given to securing a “Waiver of Limitation,” Form BOE-122. (See section 0215.15.)

When making larger audits, other information will be helpful, such as:

- The names of employees with whom the auditor will have contact.
- A list of all books and records in use and the name and location of the person in charge of the particular records.
- A list of sources of taxable transactions and how they are accounted for in the records.
- An explanatory chart of accounts.
- An explanation of the physical layout of the plant or the type of operations.
- Outside accountants’ reports, if available.
- Minute book, if a corporation.
- Copies of Federal and/or State income tax returns.

Where the taxpayer has not prepared detailed schedules in substantiation of reported amounts, such as, purchases subject to use tax and deductions, the auditor should request they prepare such schedules for the periods to be test-checked. Ordinarily, a listing of the detail in chronological sequence showing invoice numbers and amounts of each transaction will be sufficient. Additional information may be required in some cases and the auditor should advise the taxpayer as to the extent of the required information and the form in which it is to be submitted.

On completion of the above, potential areas of misplaced tax should now begin to form in the auditor’s mind.

SPECIAL CONSIDERATION — FIRE OR NATURAL DISASTER**0403.23**

Occasionally, a taxpayer will have losses of records and merchandise as the result of a fire or natural disaster (e.g., earthquake, flood). If records have been destroyed, the auditor may have to use specialized audit techniques as described in section 0407.00 to verify the taxpayer's reported amounts. The auditor should also note changes in business operations as a result of restoration, such as a different product mix or increased/decreased shelf space.

Whenever a fire or natural disaster is relevant to reporting during the audit period, the auditor should document the claimed event and loss. Examples of documentation supporting the claim include:

- A report to the police department giving the date of the event and approximate loss
- A fire department report
- A claim for loss filed with an insurance company

The taxpayer should be made aware that losses of money cannot be offset against taxable sales since the sale has already taken place and thus the tax is owed to the state.

PRELIMINARY TESTING**0403.25**

The auditor has now reached the point where a decision must be made to proceed with the audit or whether the audit should be waived as non-productive.

Informal spot or random tests of records and returns should be made for the purpose of evaluating each of the components of the reported amounts to determine which areas are likely to contain a material amount of understatement or overstatement of tax measure. To be meaningful, the tests should be short and as widely spread over the audit period as possible, emphasizing periods where there were significant changes in:

- Personnel
- Accounting methods, and
- Types of transactions

Such a test may consist of an examination of one return selected at random, verification of the figures entered thereon, and tracing the figures to the books of original entry. It also should consist of an examination of a representative number of sales or revenue tickets and the tracing of the amounts shown on the ticket to the appropriate journal. Tests should be made of purchase invoices covering supplies and expense items. A more detailed examination should be made of equipment purchases. Tax accrual accounts in the General Ledger should be examined for possible irregularities. Revenue accounts should be tested for disclosure of possible unreported sales. Similar short tests should be made to verify the accuracy of the amounts claimed as deductions. If the results of these tests indicate the taxpayer has been properly reporting the tax, the audit report should be completed using Form BOE-414-C or Form BOE-596 (see Chapter 2).

The test may result in a no change audit report or a waiver of audit assignment or the verification of certain phases of the assignment (e.g., sales for resale, etc.) The testing techniques result in actually probing into all facets of the taxpayer's business activity relating to the records maintained and the taxpayer's knowledge and understanding of the particular tax act or acts under which they operate. If this preliminary testing does develop an area of misplaced tax, then a more formal and expanded test should be developed as discussed in subsequent sections of this manual.

SURVEY OF PLANT**0403.30**

In auditing a small concern, the auditor can usually look over the place of business without making a tour of the premises. In an audit of a large firm, auditors should ask to be shown through the plant and office. This need not be done immediately. In fact, it is preferable to wait until the audit is started and the auditor has become familiar with the accounting system. This survey will help the auditor to understand many features of the operation such as the method of securing and billing orders, the method of making nontaxable sales, the processes in which material is consumed, and the use of equipment and machinery possibly purchased from out-of-state source. All of this will enable the auditor to design the audit program more intelligently. In case of widespread complex operations, the extent of the tour may be limited.

RECEIPT FOR TAXPAYER'S RECORDS**0403.35**

Whenever a taxpayer leaves his or her records at a Board office or whenever records are picked up in the field and removed from the taxpayer's premises,* a Receipt for Books and Records, Form BOE-945, must be used. Receipts will be made in duplicate, the original being given to the taxpayer or representative and the duplicate retained in the working paper file. In preparing the form, care should be taken to adequately describe the books and records.

*California retailers of cigarette and tobacco products are required by Law to keep complete and legible cigarette and tobacco product purchase invoices at each licensed location for at least one year after the date of purchase. Accordingly, auditors may not remove from the taxpayer's facilities the invoices for cigarette and tobacco products purchased during the previous 12 months. The taxpayer may provide copies of such invoices.

Form BOE-945 has a mailing address box to be checked by the taxpayer when signing the form. This new box requests the taxpayer to indicate if the mailing address listed on the form represents a change to the mailing address of record. The auditor must verify that the taxpayer completed the mailing address box. If the taxpayer did not complete the box, the auditor should request the taxpayer to provide the information prior to the auditor signing the form. If the taxpayer indicates there is a change of address of record, the auditor should confirm the correct address, make a copy of the Form BOE-945 and provide it to the appropriate account maintenance staff. If the taxpayer indicates there is no change to the official address of record, no further action is required by the auditor.

In accordance with sections 1000.100 and 1000.110 of the Information Security at the Board of Equalization handbook, when taxpayer data is in the possession of the Board it will be stored in secure, lockable areas. Thus, taxpayer books and records must be stored in a locked area when the records are not actually being used.

When the books and records are returned to the taxpayer or representative, the original receipt should be obtained with proper signature of taxpayer or representative affixed thereto indicating their return. If the original receipt is not available, the duplicate copy retained by the staff should be used to obtain receipt for return of the material listed thereon.

If the taxpayer wishes to have the records returned by mail, this should be done in such a way that the Board has the taxpayer's written instructions and a record of the shipment. The taxpayer should be asked to pay the shipping charges if they are excessive.

If the taxpayer does not respond to normal attempts to return the records, a letter should be sent to the taxpayer by certified mail at the address given on Form BOE-945. The letter should notify the taxpayer that the records are no longer needed and unless he or she responds or advises the Board within 15 days where to ship the records, the records will be destroyed as authorized by the taxpayer on Form BOE-945. To allow an ample margin of time there should be no actual destruction of the records until at least 30 days after mailing the certified letter. After 30 days, if the taxpayer's records can serve no useful purpose in connection with the tax obligation, they should be removed from the files and disposed of in the same manner as other records the destruction of which has been authorized. A record of such destruction, together with copies of Form BOE-945 and the certified letter, should be retained.

AUDIT MANUAL

AUDIT PROGRAM — PROCEDURE TO FOLLOW**0404.00****PLANNING THE AUDIT****0404.05**

This section presumes that as a result of the preliminary probing and testing as described in sections 0403.20 and 0403.25 the auditor has become aware of a potential area of misplaced tax. It is now the function of the auditor to:

- (a) Determine whether the correct amount of tax has been reported; and
- (b) If not, what is the amount of misplaced tax.

Any good auditing procedure that will expeditiously achieve this end result is the preferred procedure. The auditor must set up and design an adequate test program.

There are two basic approaches to this problem which may be named and defined as:

- (a) Direct Audit Approach — auditing the formal accounts and records of the taxpayer.
- (b) Indirect Audit Approach — where reliance cannot be placed upon the formal accounts. Illustrative of the indirect audit approach is any method used to impeach the records, e.g., mark-up of purchases, bank deposits, independent sources, etc., whether formal records are kept or not.

Depending upon the audit approach found necessary, the auditor should:

- (a) Establish a test base,
- (b) Establish test periods, and
- (c) Come to an understanding with the taxpayer to the extent possible as to:
 - Reasonableness of test approach
 - Assistance to be furnished by taxpayer in assembling or preparing test data, e.g., sales invoices, vendor's invoices, resale certificates, or EDP runs as necessary

AUDIT PROGRAM**0404.10**

All audits must be guided by an organized plan. A carefully thought-out, but flexible, overall plan (audit program) is the first step towards good working papers and a good start. Such a plan forces advance thinking and a proper overview of the assignment as a whole. As such, audit programs are mandatory and must be completed for all audit assignments. Audit programs must be written on a separate schedule and included as a memo in the audit. Much of the information needed to prepare the audit program can be obtained from the BOE-472, Audit Sampling Plan. See Exhibit 11 for sample audit programs for general retailers, manufacturers and wholesalers, and liquor stores. These sample programs may be used as a guideline in developing a program for your audit.

Audit programs are influenced by the results of the preliminary investigation, surface examination of the records, and limited testing procedures. As such, audit programs need to be flexible and are subject to change as circumstances warrant.

EXPLORATORY TESTING**0404.15**

All testing is exploratory in nature and even though preliminary testing did indicate that further testing was necessary, continuing errors are not always supported by additional testing.

The auditor is to be continuously alert to discontinue testing at the earliest possible moment they are able to determine that further testing is unwarranted. This is a cut-off technique which is discussed fully under section 0405.35. In cases of this nature, the working papers will contain appropriate comments regarding the test procedure used and the findings.

This expanded testing differs from the “spot” or “random” tests discussed in section 0403.25 in that controls are established so that projections can be made to estimate the amount of the misplaced tax. The word “estimate” as used here means the results of the test when applied to the audit period.

The “controls” mentioned here involve test periods, etc., and will be more fully discussed in section 0405.20.

Note should be made of the fact that tests sufficient to support a no change recommendation may well be short of the testing degree and completeness necessary to sustain a change recommendation.

MAKING THE AUDIT — PROCEDURES AND TECHNIQUES**0405.00****GENERAL****0405.05**

After having determined an account should be audited, it is necessary to devise an audit program. To do this, the auditor should be familiar with tax auditing techniques. The auditor should be alert to the possibility of revising the use and application of such techniques as the need arises.

Some of the special techniques and procedures are:

- Short tests
- Use of test basis
- Bank deposits
- Cut-off techniques
- Whole dollar auditing

These procedures and techniques are described in the following sections.

AUDITS ON A TAXABLE MEASURE BASIS**0405.10**

An audit made on a taxable measure basis generally places emphasis on the verification or accumulation of taxable differences as compared to an audit performed on a total sales and claimed deduction basis using individual lead schedules.

The use of the taxable measure basis should in no way be construed as relieving the auditor of his responsibility to verify that all sources of revenue and deductions have been examined or of writing verification comments thereon. Comments should cover fully the nature of the transactions verified, the audit procedure used in making the verification and the result.

There are certain cases where the taxable measure basis may be preferable:

- Where records are available, but verification of the total gross reported and deductions is not significant. The taxable transactions are few in number and the taxpayer has reported taxable measure only based on a listing of these transactions, capitalizing tax reimbursement, or by mark-up of taxable purchases.
- Where the total gross reported is not an important factor in determining taxable measure. This may apply, for example, for sales tax purposes, to service enterprises, contractors, public utilities, manufacturers and wholesalers.
- Where the records are such that an indirect audit approach is necessary and the taxable measure must be reconstructed. (See section 0404.05)
- Where the taxpayer has prepared returns on a taxable sales basis and audit time can be conserved by conforming to this method.

As an example, where a grocer has used a method other than the “grocers method” to arrive at the taxable measure or the overall mark-up, as reflected by recorded gross sales, is unfavorable, our audit might be conducted in a more efficient manner through a verification of taxable sales.

Although total gross reported loses much of its significance in audits prepared on a taxable measure basis, a comparison between recorded and reported total gross is important, for it may disclose that sales, gross receipts, or fuel used, for one month or one department or branch of a business was not included in the reported totals. This comparison also may disclose classes of transactions or use erroneously considered nontaxable by the taxpayer. If the comparison between recorded total gross and reported gross discloses unreported taxable transactions, these items should be listed on a schedule.

If the taxpayer has reported on the basis of lists or tapes of taxable items, the auditor should verify the correctness of these lists by:

- Verifying that the lists include all items regarded as taxable by the taxpayer, and
- Determining if there were any items subject to tax not so regarded by the taxpayer.

If the taxpayer has reported on a basis of tax actually charged to the customer and has credited the amount charged to a tax accrual account, the clerical accuracy of the posting to that account, as well as the computations made in converting the tax accrued to taxable measure should be verified. This will involve tests of:

- The computations of tax charged on customer's invoices.
- The posting of tax charges to the sales journal or other record where such charges are summarized.
- The clerical accuracy of the footings and the posting of the tax charges to the tax accrual account.
- The mathematics of the conversion of tax charged to taxable measure reported.

Debits to the accrual account should be scrutinized to determine that these charges represent proper deductions from the amount of tax accrued. Debits may include but are not limited to items such as:

- Payments to the Board
- Tax on cash discounts, returned sales or rescinded sales
- Tax refunded due to an overcharge or erroneous charging of tax on an exempt transaction

In addition, the auditor should determine the effect on the accrual account of allowable bad debts, tax-paid purchases resold and other adjustments which legitimately reduce the taxpayer's accrued tax liability. Many accounting systems fail to adjust the tax accrual accounts for transactions of this type.

A reconciliation of the tax accrual account and the tax reported should be made, and a summary of the tax accrual account should be prepared and included in the audit working papers when material to the audit findings. Consideration should also be given to sales and use taxes collected for and paid to other states, for tax credit allowable under section 6406 of the Sales and Use Tax Law, and for taxable self-consumed merchandise reported on Line 2 but not credited to the accrual account.

It is important that deductions claimed or netted be tested to the extent that the auditor is satisfied that they are allowable. Test procedures should be similar to those used when auditing on a total sales basis. Tests made should be as short or extensive as warranted under the particular circumstances involved. Schedules for deductions should be indexed in accordance with the system outlined in sections 0302.50 to 0302.65.

Self-consumed merchandise and purchases subject to use tax should be audited in accordance with instructions included in sections 0408.05 to 0408.40.

General or over-all verification comments should be written on summary schedules. Specific verification comments should be written on subsidiary schedules.

The auditor should recognize that not all audits should be made on a taxable measure basis. When it is necessary to verify total gross less allowable deductions, or in those audits where it is necessary to prepare lead schedules in order to reconcile recorded and reported amounts, the audit should be made on a total sales basis.

SHORT TESTS**0405.15**

Short tests are discussed in prior and succeeding sections, under Preliminary Testing (0403.25) and under Specialized Techniques (0407.00) for the various tax acts. It is the purpose here to discuss short tests as a technique.

The end result of a short test is a decision as to whether to proceed or to accept as correct that item being tested. If we decide to proceed, the short test may be expanded to anything from a short period controlled test to, on occasion, a complete examination.

A short test may be defined as the examination of any record, supplemental data, original detail, etc. for any purpose. A short test audit may be a combination of several short tests. A short test might be, for example, the review of an income tax return to see if the mark-up over cost is acceptable for the type of business, a spot check of sales invoices for proper tax accrual, etc. If the foregoing mentioned mark-up test indicates an acceptable margin and total sales per the income tax return agree with total sales reported per the sales tax returns, total reported sales might be accepted. Deductions might be accepted as claimed if, as a result of spot checking various transactions in detail (e.g., a resale sales invoice may be traced to its segregation in the sales journal as a resale, then to claimed resales, and finally to the individual resale certificate), no exceptions are noted.

A short test may be used to substantiate the auditor's recommendation for a no-change phase of an audit such as acceptance of recorded and claimed sales for resale in a sales tax audit which might be a change audit for other reasons.

The nature of the short test places a great deal of emphasis on the individual auditor's judgment. The auditor must be able to intelligently evaluate the results of a short test and come to a decision as to what to do. It is recognized that there is a "calculated risk factor" involved in arriving at a decision not to proceed. In a few cases, the decision may be in error. If the auditor arrived at the decision as a result of good logic, properly presented, they need not be unduly concerned if it is later found that some misplaced tax did exist.

To prevent misunderstanding, one other type of short test should be discussed. In certain businesses where the number of transactions are large (e.g., department stores), it may be necessary to design a controlled test for a short period. An example might be the operations of one day or less. This test, even though formal in nature vs. spot checking, would be construed as a short test because this forms the basis of a decision to stop testing or to proceed. If it is decided to proceed, this original test might be the nucleus of an expanded audit program.

USE OF TEST BASIS**0405.20**

There are two broad categories of testing used in sales and use tax auditing. The preferred category is statistical sampling, which is covered in detail in Chapter 13. The second category of testing used when statistical sampling cannot be used is block sampling and related methods. This section focuses on block sampling and related methods.

An audit made on a test basis is one in which the transactions of only a part of the audit period are examined in detail. The balance of the period is adjusted on the basis of the findings in the test periods. Such findings are usually expressed in terms of percentages of error calculated from the errors and differences disclosed in the test period. This basis assumes that the differences disclosed in the test period, which are audited in detail, will occur in the same proportion in the balance of the audit period.

(a) When to use a test period. There are certain conditions necessary before a test can be used. These are:

- Units of sale or the amounts of the items of claimed deductions are uniform as to size and distribution throughout the audit period.
- Basic characteristics of the business and the methods of reporting remain the same throughout the audit period. Should the basic characteristics of the business change during the audit period, separate tests should be made for each specific period with attendant percentages of error for each.
- The sample audited in detail contains sufficient items to make possible an accurate percentage calculation. In other words, if the sample tested has only a few transactions, errors may not lend themselves to a percentage calculation of reasonable accuracy.

(b) The test base. It is important to establish a clearly defined test base. The test base should be representative of the total population of the item being tested. There are two main points to consider in establishing the test base:

- Establish what is being tested
- Establish the period or sample to be tested

In order to establish the most representative test base possible, using available information, audit staff should compare the selected test base characteristics to the population characteristics. For example, if the taxpayer's accounting system can produce reports to show summary amounts for taxable versus nontaxable transactions, the ratio of the taxable versus nontaxable in the test base period should be similar to the ratio of taxable versus nontaxable transactions in the population.

It is important that a firm sample be established so that a percentage of error can be computed and applied. This is, in effect the denominator, the differences found in the denominator being the numerator. For example, if sales for resale are to be tested for one month, all recorded and claimed resales must be examined for that month with exceptions or differences to allowable resales being noted. It follows that what is being tested is equally important. If the item being tested is sales for resale, only resales should be considered in this particular test. If the auditor finds a sale in interstate commerce erroneously recorded and claimed as a sale for resale, this should be eliminated from the test base and all factors influencing the calculation of a percentage of error.

It may be that what is being tested is a hodgepodge of various deductions. In this case, the base would be all the deductions recorded and claimed. The most expeditious approach may then be to revert to taxable sales as the base. The auditor should ascertain that all invoices for the test periods are available for examination. Verification should then be made in accordance with the taxpayer's method of computing the claimed deduction.

If the taxpayer's method has been to capitalize the tax collected, the auditor should examine invoices representing sales to verify that:

- The tax has been properly computed and added to taxable invoices
- The tax so computed has been properly accrued in the sales tax accrual account
- The tax so accrued had been remitted to the State

All exceptions noted will be scheduled and summarized and the disallowed deduction for the entire audit period will be computed.

If the method used by the taxpayer is to deduct the sum of the taxable sales from total sales and claim the residual amount as a deduction, the auditor should verify the taxable sales only. Any exceptions should be scheduled and a percentage of taxable sales understated should be computed based on the relationship the additional taxable sales bear to total taxable sales reported. The percentage thus computed will be applied to reported taxable sales in all periods other than those listed. Use actual additional taxable sales determined for the test periods. This method is not practical when the taxable sales are very small or when they fluctuate greatly from month to month. In such case, it may be necessary to base the percentage on deductions claimed rather than on taxable sales.

The procedure under both of these methods is, in effect, auditing on a taxable sales basis (0405.10).

(c) Size of test period. Auditors must use their experience and exercise judgment in determining the size of test periods. The following principles should be considered in selecting a test period:

- The size should be adequate to insure reasonable accuracy
- The auditing time required should not be excessive in relation to the problem

In general, when auditing a business with good internal control, and a good accounting system, the test period may be a relatively small portion of the total audit period. However, in an audit of a business with little or no internal control, the test period should cover a larger proportion of the audit period. If records are available, the periods selected for test should be spread over the entire audit period so that samples can be taken of all years and all seasons of the year. The size of each test period, in addition to the above considerations, will depend on the number of documents required to be examined. Usually the test periods should consist of complete months or quarters, but periods of less than a month may be selected if daily or weekly controls can be established.

Statisticians have established that several short tests over the audit period are superior to one equivalent long period. For example, a test of three scattered months throughout the audit period will give better results than a one-quarter test.

(d) Application of the test results. If a percentage of error (whether a net underpayment or overpayment) is determined from a sample, then that percentage of error will be applied to the population tested for all reporting periods in the audit period. The percentage of error obtained in the test period may be calculated and applied to the entire audit period in the following manner:

Claimed resales (July 19XX)	\$5,000
Disallowed resales per test (July 19XX)	\$750
Percentage of error $\$750/\$5,000$	15%
Claimed Resales (Audit Period)	\$150,000
Disallowed claimed resales($\$150,000 \times 15\%$)	\$22,500

The percentage of error would then be applied to the claimed resales for each quarter in the audit period.

(e) Elimination of nonrecurring items. In making a test of the taxpayer's records to determine their accuracy, differences are sometimes found which do not appear to be a type, either in size of the transaction, kind of product sold, omission due to an unusual situation, or other reasons to include with the other differences found which are to be used in computing a percentage of error. These are normally items of considerable size, and the opposition to including them in the percentage of error is quite strong. Before handling these items as nonrecurring errors, they should be carefully scrutinized to determine whether or not they are nonrecurring errors. It is suggested that an error of this nature be similar, but not limited, to one or more of the following examples:

- The size of the item is much in excess of the normal item and occurs only at rare intervals
- The item was omitted or included due to some unusual circumstance
- The product sold is a type not ordinarily handled

If taxable sales of a nonrecurring nature are disclosed when auditing on a test basis, those sales should be excluded from the calculations of a percentage of error. For example, if a claimed resale ascertained to be taxable is of a nonrecurring nature, all sales of a similar nature should be examined for the entire audit period and the total of such sales deducted from claimed resales in the appropriate reporting periods and shown as a separate amount in the measure of additional tax. The percentage of error developed in the test periods should then be applied to the adjusted resales claimed for all periods in the audit not covered by the test. For example:

Total claimed resales in test periods	\$10,000
Nonrecurring taxable sales excluded	\$4,000
Adjusted resales	\$6,000
Other claimed resales disallowed	\$1,200
% of disallowance of adjusted resales ($\$1,200/\$6,000$)	20%*

* To be applied to adjusted resales.

In any instance where an item is found in a test which would result in a distorted answer and has an element which is out-of-the-ordinary, it can be considered, for classification, as nonrecurring. The fact that no other sales were made to that particular customer should not be considered a reason. Sufficient tests should be made in other periods to establish that items of a similar nature have not occurred.

(f) Alphabetical vs. chronological filing of detail to be tested. It will be found that some firms file their sales invoices on an annual alphabetical basis, the sales being posted to the books of original entry chronologically.

The auditor in this situation can trace the sales for resale (if again this is the item being tested) back from the sales journal to the invoice then to the resale certificate. This is a time consuming process and may be short cut by:

- Spot testing the accuracy of posting as a sale for resale.
- Determine a test base by relating to dollar volume (i.e., a one-month test may be estimated in terms of dollars by dividing total claimed resales by the number of months).
- Selecting every third, fourth, or fifth, etc. letter of the alphabet as appropriate to approximate the desired number of dollars.
- Schedule exceptions noted and in terms of dollars, schedule every invoice examined; this will give a firm base for the calculation and application of a percentage of error.
- If the auditor makes the audit soon after the start of the taxpayer's accounting year, the alphabetical invoice file may provide a reasonable size test period.

(g) Statistical sampling techniques. The use of statistical sampling as a means of testing has some very real advantages. The Board encourages testing with statistical sampling techniques if it is feasible. Statistical sampling is fully discussed in Chapter 13.

(h) Discussion with the taxpayer. The auditor should, whenever possible, discuss the use of test periods with the taxpayer, include the taxpayer in the development or selection of a sampling plan, and endeavor to obtain a concurrence. Often such a discussion will be of material assistance in selecting representative test periods and the test base. Please note, a Form BOE-472 is required to be used for audits with a cell designation 1D through 4D (section 0405.23) or any time sampling is performed. (See section 0404.05)

(i) Use of a test basis with no supporting detail. An audit made on a test basis where there is no supporting detail (i.e. — no detailed journals) is conducted similarly to a detailed audit where there is no support for the claimed amount. However, the taxpayer should be requested to prepare supporting schedules for the test periods only. Invoices submitted by the taxpayer should be examined in detail and all transactions verified in the usual manner. The difference between the amount verified and the amount claimed will be disallowed in the same manner and to the same extent as in a detailed audit, and a percentage of overstatement of the deduction will be computed. This will be true regardless of whether complete details of the claimed deduction have been furnished.

For example:

Resales claimed for test periods	\$2,500
Total of sales for resale invoices presented for examination	<u>\$2,300</u>
Difference	\$200
Total resales verified from invoices presented	\$2,000
Amount disallowed (\$2,500 – \$2,000)	\$500
Percent of disallowance (\$500 / \$2,500)	20%*

* This percentage of disallowance is to be applied to all periods of the audit other than the test periods. (Actual amount disallowed will be used for the test periods.)

- (j) **Accepting sample elements as a result of a reply to an XYZ Inquiry.** In a verification test of resales where a sample of the vendor's sales for resale is questioned, situations may develop as a result of the nature of replies from purchasers in which consideration must be given to accepting an element from the test sample.

When an XYZ response states that use tax has been or is to be paid to the Board and it is apparent the action was taken after the receipt of the XYZ, the item being questioned should remain part of the sample to develop the percentage of error. This audit approach recognizes that similar transactions have occurred in the untested periods and that those purchasers will not receive such notification and not be prompted to report and pay the use tax to the Board. However, an adjustment for the actual amount of the tax reportedly paid by the purchaser should be made in the vendor's audit.

In those cases where the purchaser replies that the tax has been paid to the Board and it is apparent that payment was made prior to receipt of notification that the sale was being questioned, the reply should not be counted as an error. However, the questioned transaction should remain in the sample base on which the percentage of error is computed.

There may also be cases where the purchaser's statement is questioned after checking the permit information in the system (TAR AI, REV FZ, AUD MC, etc). The auditor may find that the item has been in inventory for an extended period of time, or the purchaser is in a line of business not normally selling such items, or the purchaser has reported no or very low sales. In such situations, the auditor should not reject the response without performing further verification. If the auditor does not accept the reply to the XYZ letter as support for the claimed sale for resale, the questioned transaction should remain part of the sample.

In all of these situations, a BOE-1164 should be prepared advising the district office in which the purchaser's account is located that the purchaser either has indicated that the use tax was or is to be paid on the questioned sale(s) item(s) or that the item(s) is still held in resale inventory.

See section 0409.51 for a discussion regarding XYZ non-responses.

- (k) **Analyzing sample results for reasonableness.** The proposed measure resulting from the projection of the sample results must be compared and analyzed for reasonableness by looking at the taxpayer's business as a whole. This type of analysis does not necessarily involve preparing a schedule to evaluate the impact, but the auditor must be alert to indications that the projection of the sample results is possibly unreasonable. If the results appear unreasonable, the auditor must discuss the situation with the taxpayer. The auditor and the taxpayer should come to some agreement as to whether or not the results are representative of the business for the time period in question.
- (l) **Missing Documents** — If, during the course of a sample, a document cannot be located, normal auditing procedure requires the auditor to ascertain the reason for the missing or incomplete documents. When the investigation fails to reveal any specific reason, the auditor may first determine whether there is any acceptable alternative evidence. Fortunately, as more and more companies are converting to true paperless systems, it is generally not difficult to obtain a considerable amount of data about a missing invoice. The only statistical requirement is that an audited value be established for each sampling unit.

If missing invoices would create a material error and the taxpayer objects to the sample, the auditor may want to discuss possible alternatives with their supervisor.

Based upon the facts of the situation and guidelines presented in this manual, the auditor and the taxpayer together shall discuss whether to consider missing or incomplete documents as incorrect (in error), correct (no error), whether to substitute another sample unit, or whether they should be removed from the sample base and projection.

Alternative procedures that can be considered, if appropriate, when missing documents are encountered include:

- (1) The taxpayer and/or auditor can contact the vendor or customer for a copy of the missing or unreadable documentation.
- (2) Allow the taxpayer to produce additional documentation on similar transactions for the same customer or vendor. The auditor can decide whether or not the taxability of the transaction(s) with missing documentation is similar to the transactions for which documentation is provided.
- (3) Remove the missing item from the sample base and population.

(m) Timing — The auditor must take care to be aware of timing differences between the date of a transaction and the date it is recorded by the taxpayer. For example, paid bills are frequently recorded when paid rather than on the date of the invoice.

See section 1305.25(d) for a discussion of installment payments.

USE OF FORM BOE-472, AUDIT SAMPLING PLAN

0405.23

In an effort to document the sampling method used in an audit, the Board has developed Form BOE-472 — Audit Sampling Plan. (See Exhibit 5) Its purpose is to establish the most efficient means of developing a sampling plan and document: (1) the sampling method that will be used to determine a percentage of error in the population being tested and (2) the projection of the sample results.

The purpose of the BOE-472 is to establish the most effective and efficient means of developing a sampling plan. This form must be used in all large audits (defined here as any audit with a cell designation of 1D *through* 4D) or *any time sampling is performed*. This plan will provide much of the information that will later be needed to complete the working paper documentation and audit comments.

Prior to determining the type of testing to be used in a given audit situation, the auditor must make a thorough examination of the business operation for the period under audit. This examination should include a review of source documents, changes in business activity, and changes in accounting procedures and key personnel. Once this information has been evaluated, a determination of the best method of testing can be made. Form BOE-472 will assist the auditor and taxpayer in identifying crucial elements of the audit sampling plan. This form is to be used as a tool to gather information in conducting samples, as well as to educate taxpayers about the sampling process and make the taxpayer aware of important considerations that might impact the audit. This form also identifies special situations that might arise during a test and allows both the taxpayer and auditor to agree on how to handle them. It should be completed with assistance and input from the taxpayer, prior to the actual selection of the sample, and used in conjunction with information and guidelines provided in the appropriate sections of the Audit Manual.

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 audit process. However, if any deviation from this sampling plan is required, the deviations will be fully explained and discussed with the taxpayer.

While BOE-472 includes many situations that might arise in sampling, it cannot include them all. As such, the form should be modified (in Section 11, "Other") to address any situations not included in previous sections of the form. Once the information has been evaluated, the auditor is in a position to determine the best method of testing.

This form is to be included in the audit working papers as a subsidiary schedule. A separate plan should be completed for each area tested. For example, if the audit includes a sample test of both paid bills and resales, two BOE-472s should be completed. (Exhibit 5)

BANK DEPOSITS

0405.25

In cases where the taxpayer has maintained a bank account, the bank deposits may be a more accurate source of determining gross receipts than recorded figures. There are two methods of estimating gross receipts on the basis of bank deposits:

- (a) Where records of deposits are available for the entire period, they should be scheduled for that period.
- (b) Where records of deposits are available only for a portion of the audit period, a percentage of error should be computed and then applied to recorded or reported sales for the remainder of the period.

In either method, the bank deposits should be scheduled by months from the bank statements, from the bank deposit books if verified as reflecting all deposits, or from data furnished by the bank. The record of cash deposits must be adjusted for certain types of transactions which will affect total receipts, namely:

Increases:

Cash expenditures and withdrawals from cash receipts before bank deposits are made.

Decreases:

Deposits representing receipts from sources other than sales, i.e., loans, redeposits of NSF checks, rental income from real property, charges relating to cashing customers' checks, etc.

Other:

The auditor should be alert to such items as possible trade-ins, returns of merchandise sales, changes in accounts receivable, etc.

If the taxpayer has a record of cash pay-outs, the totals by months should be scheduled. If no such record exists, pay-outs for merchandise sometimes can be estimated by examining the check record or canceled checks to determine which types of merchandise are paid by bank checks. For instance, a restaurant may pay by check for meats, groceries, produce and dairy products, but pay cash for its daily needs of bakery goods, soft drinks, candy, etc. The latter purchases, as well as cash withdrawals, may be estimated after a conference with the taxpayer.

Credits for loans and increases in capital must be supported by documentary evidence in the form of canceled notes, letters from banks, savings bank books showing withdrawals, etc. The non-taxable receipts must be traced to bank statements to verify the amount and date of those deposits. Where vending machines are on the premises, copies of statements of settlement from the operators can be used to verify income from these sources.

In most cases, when this method of estimating receipts is used, either no record of accounts receivable is available or accounts receivable balances are so small they are not taken into account.

When there is a record of accounts receivable and there is an increase in receivables between the beginning and end of the audit period, the increase should be added to the last quarter. In unusual cases, where the increase is a large factor in the audit, it should be prorated to quarters.

The auditor should at all times be alert for evidence of bank accounts for which the taxpayer has not produced statements or deposit books.

Bank deposits are useful in determining gross receipts for sales tax audits. Bank deposits may also be used as a short test to see if there is a reasonable relationship between cash receipts and recorded gross receipts; their use otherwise would be as an indirect audit approach.

OBTAINING FINANCIAL INFORMATION

0405.27

Board staff must first try to obtain from the taxpayer any data or documents which should have been retained in accordance with Revenue and Taxation Code section 7053. However, if all other available avenues of information have been exhausted and approval of the district administrator has been obtained, Board staff may request the information directly from the taxpayer's financial institution either by obtaining the taxpayer's authorization or by issuing a subpoena duces tecum.

Procedures for requesting records directly from a financial institution, including procedures to comply with the California Right to Financial Privacy Act, are explained in detail in CPPM sections 135.070 through 135.073.

MARK-UP METHODS

0405.30

Use of mark-up methods as an audit procedure is widespread in sales tax auditing and are discussed under specialized techniques (section 0407.10).

The auditor is cautioned not to rely too heavily on mark-up percentages (gross profit divided by cost of goods sold) for all types of businesses. It may be time consuming to obtain and have little meaning. For example, in a wholesale or manufacturing operation having little in the way of taxable sales, a mark-up percentage calculation would have little meaning.

USE OF PRIOR AUDIT PERCENTAGES OF ERROR IN CURRENT AUDITS 0405.33

This program involves the use, under certain circumstances, of a percentage of error developed in a prior audit for the sales or accounts payable portion of a current audit. The techniques used in the prior audit 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 one prior audit. The most recent prior audit and the current audit must indicate consistent 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 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 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

The memo outline should be approved by the District Principal Auditor and maintained in the audit as a memo schedule. 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.

The evaluation memo must include the tax change of the 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 outline memo should be 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.

WHOLE DOLLAR AUDITING**0405.40**

The principle of dollar auditing (i.e., dropping cents) is a time-saving technique. In whole-dollar auditing, cents are eliminated at the earliest practical stage in an accounting sequence and only whole-dollar amounts are recorded thereafter.

(a) Rules that apply when rounding to whole dollars:

- Eliminate cents between \$.01 and \$.49 (e.g. \$7.18 becomes \$7)
- Increase to next dollar, cents between \$.51 to \$.99 (e.g. \$5.72 becomes \$6)
- Round \$.50 amounts to the nearest even dollar (\$17.50 becomes \$18; \$18.50 also becomes \$18).

Do not show a decimal point or place figures or symbols in cents columns when amounts are rounded to whole dollars.

(b) Treatment of variances:

The sum of whole-dollar amounts will often differ by a few dollars from the sum of the exact amounts. For tax auditing purposes, this is not important since the variance in terms of tax is negligible.

These small variances (usually less than \$5) will be dropped at the first convenient place they can be identified in the working papers. Variance differences standing alone are easily discernible. Variance differences commingled with clerical errors or errors on returns are not easily discernible and need not be dropped.

An example of a column to eliminate rounding variances in lead schedules is shown in Exhibit 7. In some cases, it is possible to drop readily identifiable variance differences in subsidiary schedules.

(c) Common situations where whole-dollar auditing should not be used are:

- When a taxpayer objects. A brief explanation to the taxpayer may overcome this objection.
- When computing markup from shelf tests.
- When basic data must be compiled with accuracy to avoid distortions when the findings are expanded, e.g., computing a percentage of error.
- When items to be scheduled do not reflect normal distribution of fractional dollar amounts, such as when repetitive purchases at one given price are made, or when sales are made under a policy of pricing at only slightly less than whole dollars.

WORKING PAPERS**0405.45**

Chapter 3, Audit Working Papers, contains the basic information relating to audit working papers.

Usually each portion of an audit, namely, total sales, self consumed merchandise, sales for resale, etc., should be considered as a separate unit with separate working papers for each unit.

MAKING THE AUDIT — APPLYING PROCEDURES AND TECHNIQUES **0406.00**

GENERAL **0406.05**

While the basic tools given to the auditor in this chapter are guides, there is nothing which will replace initiative, ingenuity and judgment in applying, adapting and improvising as necessity warrants.

The following sections briefly describe the books, records and detail that the auditor will normally encounter in making audits. All or part of these described records may be used in performing any given audit and they may be used in either a direct or indirect audit approach.

EXAMINATION OF GENERAL LEDGER ACCOUNTS **0406.10**

The general ledger accounts must be examined for debits and credits which may represent unreported taxable transactions. As examples, sales of merchandise at cost may have been credited to the purchase or inventory accounts; sales of by-products may have been credited directly to profit and loss, surplus or expense accounts; sales of furniture, equipment and other capital assets may have been credited to equipment, depreciation or other accounts. Debits to general ledger equipment and supply accounts may represent unreported purchases subject to use tax.

EXAMINATION OF GENERAL JOURNAL **0406.15**

Transactions not disclosed by examination of other records may sometimes be disclosed by examination of the general journal. The auditor should examine general journal entries noting those which may indicate unreported taxable transactions.

All data pertaining to these entries should be examined; such as, correspondence, contracts, invoices and other documents to determine whether the entry represents an unreported taxable transaction.

EXAMINATION OF CASH RECEIPTS AND DISBURSEMENTS RECORDS **0406.20**

The cash receipts record should be examined to determine that receipts from cash transactions have been credited to the proper sales or revenue accounts. Care should be exercised not to duplicate taxable transactions disclosed in the examination of other records.

EXAMINATION OF ACCOUNTS RECEIVABLE LEDGER **0406.25**

The accounts receivable with the owners, partners, officers, or employees of the company should be examined for evidence of taxable transactions not otherwise recorded in the sales or revenue accounts. Partners' drawing accounts and employees' advance accounts should be examined.

EXAMINATION OF PURCHASE JOURNAL **0406.30**

Entries may be made in the purchase journal for sales at cost or returned merchandise. Inventory withdrawals which should have been reflected in the inventory accounts may appear as credits in the purchase journal. These postings should be scrutinized for taxable transactions.

SCHEDULE OF TOTAL SALES OR REVENUE**0406.35**

Unnecessary scheduling should be avoided. However, good auditing procedures should always be kept in mind. Time can usually be saved by reconciling the sales or revenue reported to the general ledger accounts. Taxable differences, where encountered, can be transferred to the Schedule 414–A2, Summary of Differences, when conducting a total sales or Line One audit.

In some cases, it is more practical to trace the reported figures to the sales or revenue journal or general ledger by periods. If there are frequent differences appearing, it would be advisable to schedule total sales or revenue. If there are only a few isolated differences, the periods where the differences occur should be scheduled. When the recorded figures can be used in tying-in several items such as total sales and several deductions, a detailed schedule of total sales may be advisable. This may be scheduled from the sales journal if the segregation between taxable and nontaxable sales are not shown in the general ledger.

Where the sales are scheduled from the sales journal or other detailed sources, the scheduled figures should be reconciled with the general ledger.

In all cases, proper planning is necessary to determine the correct method to be used for the assignment. Verification comments should always indicate the general method of reconciliation used.

GROSS PROFIT AND NET WORTH ANALYSIS**0406.40**

The auditor will encounter some cases where the taxpayer has no records of any kind, or perhaps only fragmentary records. Where this condition exists, sales must be estimated as accurately as possible based on whatever information is available. In order to estimate sales, it must be assumed that gross profit equals increases in capital assets, operating expenses, and net withdrawals of the proprietor. Algebraically, this is expressed as follows:

- (a) $\text{Gross Profit} = \text{Sales} - \text{Cost of Goods Sold}$
- (b) $\text{Cost of Goods Sold} = \text{Gross Profit} \div \text{Mark-Up \%}$
- (c) $\text{Mark-Up Percentage} = \text{Gross Profit} \div \text{Cost of Sales}$
- (d) $\text{Gross Profit} = \text{Capital Asset increases} + \text{Expenses} + \text{Withdrawals}$
- (e) $\text{Sales} = \text{Cost of Goods Sold} + \text{Capital Asset increases} + \text{Expenses} + \text{Withdrawals}$

The items to be determined are:

- Percentage of mark-up
- Capital asset increases, operating expenses and withdrawals.

The percentage of mark-up may have to be estimated based on auditor's knowledge of mark-ups of similar type and size of business located in the same general area. If at all possible to do so, a mark-up should be computed based on current purchase invoices which may be available. This mark-up could then be compared to the known mark-up of similar businesses as a test of its accuracy.

Increases in capital assets, operating expenses and the proprietor's net withdrawals must be compiled from data and estimates based on information derived from questioning the taxpayer and other persons who have knowledge of the business. Information regarding increases in capital assets may be obtained by noting new equipment, machinery, etc., and determining the equity held by the taxpayer, etc. Average operating expenses may be estimated from canceled checks of records of expenditures; wages may be taken from social security records; rent from rental agreements. Withdrawals by the proprietor may be estimated from canceled checks, bank deposit books, investments, etc.

MARK-UP BASED ON INCOME TAX RETURNS**0406.45**

In many instances, income tax returns are no more accurate than the records from which they are compiled. The income tax returns, however, may be of aid to the auditor in supporting sales estimated by using one of the methods outlined above. For example, where the taxpayer's records have actually been lost or destroyed, the income tax returns may be compared with the sales estimated by using procedures set forth in section 0406.40. This procedure is, of course, based on the premise that at the time the income tax return was compiled the taxpayer was in possession of their records. Where there is a discrepancy between the purchases and sales per the records and the purchases and sales per the income tax return, the taxpayer should be requested to account for such differences. Consideration must be given to purchases and receipts which do not represent sales of tangible personal property.

INCOME TAX RETURNS AS BASIS OF AUDIT**0406.50**

Where a taxpayer has acceptable records, but gross receipts recorded in the books and reported on business tax returns are not in agreement with gross receipts on the income tax returns, these differences should be reconciled if possible. In making this reconciliation, differences due to netting of, for example, sales tax from gross receipts per the sales tax return should be recognized. Another example of this would be reporting for income tax purposes on a cash basis vs. an accrual basis for sales tax purposes.

EXAMINATION OF SALES OR REVENUE INVOICES**0406.55**

Sales or revenue invoices usually represent the original record of a transaction after an order of execution, such as a purchase order has been given. In the process of most of our audits under the various tax acts, it is a necessary part of the audit procedure to examine a representative number of these invoices to determine how the transaction is recorded thereon and in the case of reimbursable taxes, on what the tax was accrued.

Following is an itemization of the various functions involved in the examination of this original detail:

- (a) **Postings.** This is the first step in the verification of the accuracy of the books of original entry. The invoice, sales or revenue, is vouched directly to the sales or revenue journal for accuracy of posting relative to amount and classification in the journal.
- (b) **Tax accrual.** On those taxes subject to reimbursement (i.e., sales and use tax), the tax as accrued on the invoice is important for reasons such as:
 - Accrual of the tax based on the measure, i.e., sales tax rate times the selling price. This would relate to audits verifying the taxpayer's reporting on an accrual of tax basis, and
 - The provisions of Regulation 1700 of the Sales and Use Tax Law concerning excess tax reimbursement.
- (c) **Deductions.** At the time the invoice is being reviewed for posting accuracy, etc., it also, will be reviewed for evidence of exemption or non-taxability. For example, if a sale is being claimed as an exempt sale for resale, the resale certificate itself could be examined at that time.

(d) What is the form of the invoice, i.e., are the charges segregated; are they lump sum charges, etc.? The importance of this will relate to the particular tax act. For example, sales tax vendors are, under certain conditions, allowed to bill lump sum where they consider themselves to be consumers rather than retailers of the property used in repairing tangible personal property.

In summary, it cannot be overemphasized that the sales or revenue invoice is of prime importance in the audit process and any information found thereon is worthy of consideration; the importance then extends from the document itself to what is done with it in the process of recording.

CONCESSIONAIRES

0406.60

For sales and use tax purposes, concessionaires are independent retailers who are authorized, through contract with, or permission of, another retail business enterprise (the prime retailer), to operate within the perimeter of the prime retailer's own retail business premises. Concessionaires appear to be wholly under the control of the prime retailer, and to make retail sales that to the general public might reasonably be believed to be the transactions of the prime retailer. The usual bases for payment of store occupancy to the prime retailer are:

- (a) Percentage of net or gross sales with possible provision for minimum rental payment
- (b) A fixed rental
- (c) A profit-sharing arrangement

The prime retailer's general ledger should contain a clearing account for concessionaire operations. The prime retailer may be held jointly and severally liable for sales and use taxes imposed on unreported retail sales by the concessionaire while operating as a concessionaire. The prime retailer will be relieved of this liability for the period in which the concessionaire holds a permit for the location of the prime retailer, or the prime retailer has a written statement (as provided in Regulation 1699) taken in good faith in which the concessionaire affirms that he or she holds a seller's permit for the prime retailer's location.

If the prime retailer has concessionaires, the auditor should secure a complete list of all leased departments operated during the audit period, showing the concessionaire's name, address, phone number, and seller's permit number, if any. Even when the prime retailer does report the concessionaires' sales transactions, special attention should be given to the possible liability for use tax of the concessionaire for operating supplies, giveaways, etc., since these are often shipped into California from the concessionaires' out-of-state home office or purchased from out-of-state retailers.

SPECIALIZED TECHNIQUES — SALES AND USE TAX**0407.00****GENERAL****0407.05**

A tax auditor is concerned primarily in ascertaining whether the reported tax liability is substantially correct.

When it is determined that a taxpayer's records are such that sales cannot be verified by a direct audit approach, the auditor must estimate the sales from whatever information is available. The following sources of information and procedures have been found useful in determining probable sales:

- Bank deposits (section 0405.25)
- Gross profit and net worth analysis test (section 0406.40)
- Income tax returns (section 0406.50)
- Purchases plus mark-up (section 0407.10)

If enough information is available to do so, the auditor should use two or more of these methods to estimate the sales, comparing the results of one method against the results of another.

Note should be made of an additional factor which might be considered when the propriety of the recorded sales is questioned. This is the net profit. A continuing low net profit or loss would be indicative of a possible understatement of total sales. The value of this consideration is substantive only to other findings.

MARK-UP METHODS**0407.10**

Mark-up procedures to determine audited sales (i.e., gross sales, sales of a deduction or taxable sales) are a vital part of sales tax auditing. The auditor should expand on this use whenever the opportunity presents itself.

Mark-up, sometimes expressed as mark-on, is the amount added to cost to obtain the sales price, and generally is referred to in terms of percentages. The percentage of mark-up is computed by dividing gross profit by cost of goods sold: $G.P./C.G.S. = \% \text{ of M.U.}$ Taxpayer's often discuss gross profit in terms of percentages based on sales (i.e., profit margin) but seldom discuss mark-up based on cost. Care should be exercised by the auditor to make certain they are on common ground with the taxpayer when discussing gross profit and mark-up percentages.

Mark-up factor is the factor by which cost of sales is multiplied to determine total sales: $C.G.S. \times M.U.F. = S.$ The mark-up factor always will be the percentage of mark-up plus 100%. In computing sales, the mark-up factor should be used as it saves one step (adding the amount of the mark-up to cost of sales) in the computation of sales. The mark-up factor is obtained by dividing sales by cost of goods sold: $S./C.G.S. = M.U.F.$

Before proceeding, one other point should be made. Mark-up as previously discussed may be used to determine sales; it may also be used as a short test in examining the mark-up produced by the taxpayer's records. Is this mark-up satisfactory for the type of business involved? If it is, this may satisfy as verification of total sales, etc. This same technique may be used to verify a deduction. For example, sales of food products in a liquor store.

A mark-up test and/or procedure to determine sales is only as reliable as the base from which the auditor is working or in other words, purchases or if available, cost of goods sold. Verification of purchases is discussed in a subsequent paragraph.

In many types of businesses, particularly where the unit of sales is small, the volume of transactions relatively large and the mark-up does not fluctuate greatly, the sales may be estimated with a fair degree of accuracy by establishing the mark-up from a shelf test and applying the computed mark-up to the cost of sales. This procedure applies to audits of such concerns as restaurants, small retail stores of all kinds, and under certain conditions, to audits made on the basis of taxable sales. The following items must be considered in this type of audit:

- (a) The determination of total purchases
- (b) The segregation of purchases between departments or types of merchandise having the same general level of mark-up
- (c) Self consumed merchandise
- (d) Shrinkage of inventory
- (e) Inventory adjustments
- (f) The computation of mark-up for each department or class of merchandise

Verifying total purchases (Item a). Where a record of purchases is available, the monthly or quarterly totals should be tied-in for the entire audit period. These should be proved by comparing purchase invoices to recorded purchases on a test basis to insure that total purchases have been recorded. In many cases, however, a record of purchases will not be available. Under those circumstances, the purchase invoices should be scheduled for a test period. The auditor should make sufficient tests to determine that all purchase invoices are on hand. Recommended tests are:

- Scrutinize accounts payable for names of vendors with no supporting invoices.
- Ascertain names of brands and types of merchandise carried by a personal inspection of the stock and compare with invoices submitted by the taxpayer.
- Examine canceled checks or check stubs.
- Examine record of cash paid outs.
- Examine vendor's monthly statements for completeness of invoices.

When the auditor is doubtful that all purchase invoices are available, purchases for a test period should be obtained from a representative number of vendors. If it is found that the taxpayer's records are incomplete, some or all of the purchases should be obtained from all vendors' records. This procedure should be used in extreme measures only as it is usually very time consuming.

Segregation of purchases (Item b). If there are widely different mark-ups in the various departments or types of merchandise, the purchases, if possible, should be segregated into classes to facilitate the application of appropriate mark-ups. Before adopting this procedure, however, the auditor should make sure that the purchases can be so segregated. If they cannot, an average weighted mark-up applicable to all purchases should be computed. Following are some of the frequently used segregations:

- | | |
|---|---|
| <p>(a) Drug Stores</p> <ul style="list-style-type: none"> • Proprietary drugs (non-prescription) • Ethical pharmaceuticals • Drug sundries • Tobacco products • Notions, stationery and supplies • Liquor • Fountain supplies • Food products • Newspapers and magazines | <p>(c) Liquor Stores</p> <ul style="list-style-type: none"> • Distilled spirits • Beer • Wine • Soda • Food • Tobacco products • Newspapers and magazines • Other merchandise |
| <p>(b) Service Stations and Garages</p> <ul style="list-style-type: none"> • Tires and tubes • Oil • Grease • Parts • Accessories • Batteries • Gasoline | <p>(d) Clothing Stores</p> <ul style="list-style-type: none"> • Garments • Accessories • Shoes • Miscellaneous merchandise |

Self-consumed merchandise (Item c). The recorded cost of goods sold should be reduced by the cost of merchandise consumed by the taxpayer, given to employees, or given to customers for promotional purposes. If self-consumed quantities are not supported by the records, a reasonable estimate should be made with the assistance of the taxpayer. The estimate should contain an analysis of the self-consumption by categories to support the allowance. For example, in an audit of a bar the audit workpapers should include a schedule showing the number of drinks (broken down by liquor, beer, and wine) in each of the following categories:

- Self-consumed by owner and family
- Consumed by employees
- Gifts/give-aways

Each category should then be costed out to arrive at the total self-consumption allowance. The dollar value of each category should also be translated into the percentage of total taxable purchases. If an allowance greater than 3% is being recommended, complete justification must be included.

Shrinkage of inventory (Item d). An allowance should be made for pilferage, spoilage, theft, natural disasters and fire losses where applicable. When shrinkage is present, an amount of up to 1% of the cost of these items may be allowed. When the taxpayer claims shrinkage of more than 1% they must substantiate the amount. This substantiation may consist of police reports, reports from regularly employed security guards, private detective agencies or similar service firms, insurance claims, as well as losses computed through sales and inventory reconciliations.

Detailed comments supporting the pilferage allowance should be included in the audit work papers. The pilferage allowance should also be translated from a percentage to dollars and a breakdown of the volume and type merchandise the dollars represent, included in the audit work papers.

In the absence of detailed data, a reasonable estimate of pilferage, spoilage, theft, or fire losses may be made based on available data from:

- Police reports
- Insurance claims and settlements
- Inventory (for fire loss and large theft claims)
- Type, size and location of store, and availability of inventory for pilferage

When a merchandise shrinkage allowance is given, it should be set out as a separate item; not buried in the mark-up used. (See the illustration under item “f” — Calculation Mark-up)

Inventory adjustments (Item e). In many cases, the taxpayer will not have inventories which can be checked for accuracy. In this event, the purchases may be considered the cost of sales if there is evidence that inventories were substantially constant.

Inventory adjustments are especially critical in making audits on new businesses and close-out businesses. If adjustments are not made it may result in assessing tax on goods not yet sold.

Calculation of mark-up (Item f). The accuracy of an audit based on purchases marked up to selling prices depends principally upon two factors; the correctness of cost of sales and the accuracy of the calculation of mark-up. The cost and selling price must be known to compute the mark-up.

This procedure contemplates the auditor will make an actual examination of price tags, price stickers, signs or any other device used to inform the customer of the unit sales price.

In those instances where the audit is not made at the taxpayer’s place of business or when it is either impractical or impossible to determine the taxpayer’s posted unit sales prices, the auditor should use standard catalogs or price lists. For example, when auditing liquor stores under these circumstances, the auditor may use the retail prices listed in Patterson’s Guide or the Beverage Industry News.

If all items sold are marked up by approximately the same percentage, a straight average may be used. However, if the mark-up on the several classes of purchasers varies materially, a mark-up should be computed for each of the classes or a weighted mark-up should be computed. The weighted mark-up is usually based on dollar volume of purchases although the units purchased and units sold method may be used to an advantage in certain instances. The most commonly used methods of computing mark-up are in order of preference:

- (1) Weighted average; purchases of one or more purchasing cycles
- (2) Segregation of classes of merchandise
- (3) Average of selected items

Effect should be given to mark-downs where they can be established.

Mark-up for periods outside of the audit period may be used when current records are so incomplete as to prohibit establishment of a current mark-up.

The calculation of mark-up, based on cost, is illustrated by the following example:

Sales (Ex-tax)		\$25,000
Cost of Sales:		
Inventory 1-1-XX	\$2,000	
Purchases	20,606	<u>\$22,606</u>
Inventory 12-31-XX	<u>7,000</u>	
Cost of Sales per Books & Records	\$15,606	
Adjustments:		
Self Consumed	\$400	
*Shrinkage (pilferage)	<u>152</u>	<u>-552</u>
Adjusted Cost of Sales		<u>15,054</u>
Gross Profit		\$ 9,946

$$\text{Mark-up} = 9,946/15,046 = 66.10\%$$

*pilferage based on COS after adjustments allowed for self consumption.

Mark-up based on weighted average (Item 1). Total purchases for at least one purchasing cycle should be used to determine the weighted mark-up. Depending on the type, size and purchasing habits of the business, a purchasing cycle could cover a period from one week to six months. When the purchase invoices have been pulled for the test period, the taxpayer should be requested to price all invoices at retail. Those prices should then be test checked with shelf or list prices. The total purchase price and total sales prices of each invoice can then be recapped and from the total costs and selling prices, a percentage of mark-up can be computed. This percentage can be applied to quarterly cost of sales if such figures are available, to estimate quarterly sales. If quarterly totals are not available, the percentage of mark-up can be applied to cost of sales on an annual basis and any understatement of taxable sales developed can then be allocated to the quarters in each year on a sales ratio basis.

Mark-up based on purchase segregation (Item 2) This method of computing a mark-up is best suited to retail stores whose merchandise categories are few in number, sharply defined and with a wide variance in mark-up and sales volume. Purchases must be recorded in a manner which will allow verification of segregation in a minimum amount of time, not only for the test period but the entire period being audited. The auditor will determine the cost price and sales price of each category of merchandise for a representative test period.

Individual mark-ups will be computed for each class of merchandise. The percentages of mark-up thus computed will be applied to their respective purchase category over the entire period of the audit. Before using this method, the auditor must determine that an accurate segregation of purchases can be made over the entire audit period. If such segregation is not possible, this method should not be used. Wherever inventories are available, the mark-up is to be applied to cost of sales. Otherwise, purchases may be considered to be cost of sales.

Mark-up based on average of selected items (Item 3). This method of computing the overall mark-up may be used in certain types of businesses where the units of sale are generally small and the mark-up and sales volume of the various kinds of merchandise handled do not vary materially. The use of a straight average mark-up computed from shelf prices of representative items will usually be sufficiently accurate for this kind of audit. Such items should be included in the computation approximately in proportion to the volume of each class of merchandise handled. Slow moving merchandise and unusual merchandise not regularly sold should not be used in computing the mark-up. The percentage of mark-up computed should be applied to cost of sales for the audit period. Any substantial error in reporting revealed by a comparison of sales computed by this method and reported can be allocated against all quarters of the audit period on a percentage basis. If adequate records are not available to reflect cost of sales for the audit period, representative periods may be selected to compute estimated sales. The results of these periods can be projected to all periods on a percentage of error basis.

When sales computed by a mark-up method indicate only a small understatement, sound judgment must be exercised in concluding whether the difference actually represents an understatement rather than inaccuracies in the mark-up procedure. In reaching such a conclusion, consideration should be given to all available facts.

In addition to the foregoing, the auditor is referred to other chapters of this manual for specific application of mark-up methods and techniques; such as, Chapter 8, Bars and Restaurants and Chapter 9, Grocers.

SHORT TESTS**0407.15**

The tax returns of some types of small concerns may be proved approximately correct or incorrect on a short test basis (0405.15) by verifying certain essential information. Listed below are examples of the types of information which may be considered in short tests:

(a) Small markets or grocery stores:

- Records show an adequate mark-up on cost
- Purchases subject to use tax were properly reported
- Computation of the food product deduction on an over-all basis for the period of audit show it to be reported substantially correct
- The ratio of taxable sales to total sales is approximately correct after giving consideration to the size, type, and location of the store

(b) Small service stations and garages:

- Taxable sales reported appear to be correct based on observation of size, type, location and size of inventory of taxable merchandise
- Purchases subject to use tax, such as grease, tools and supplies have been reported
- Taxable and over-all mark-up is satisfactory

(c) Small retail stores:

- Bank deposits, after adjusting for nontaxable income, and cash paid-outs are in agreement with reported sales
- Sales tickets show proper application of tax
- Over-all mark-up is satisfactory

(d) Small restaurants and lunch stands:

- Purchases include all types of food ordinarily sold in the business
- The mark-up is satisfactory
- The deduction for food products for consumption off premises is reasonable and properly supported

(e) Bars:

- Sales computed based upon mark-ups determined from short tests, applied to merchandise purchases on an over-all basis are in reasonable agreement with those reported
- Self-consumed taxable merchandise as reported is adequate for this operation

VERIFICATION OF RECORDED TOTAL SALES**0407.20**

If recorded sales have been scheduled or reconciled with reported sales, sufficient verification should be made to prove their accuracy and to disclose any taxable sales not entered in the regular sales account. Additional taxable sales developed in this examination should be scheduled on a subsidiary schedule if few in number. However, if numerous unreported sales in different sales categories are disclosed, a separate subsidiary schedule should be used for each class of unreported transactions.

CASH REGISTER SHORTAGES**0407.25**

Questions are frequently raised about amounts classified as “cash register shortages”. Factors which may cause differences between sales recorded on the cash register and cash and valid sales checks received are as follows:

- (1) Sales are rung on the cash register incorrectly, are then re-rung correctly, but the sales clerk fails to cancel (void) the first ring.

Erroneous duplicate over-rings are allowable as a reduction of sales.

- (2) Sales are recorded on the register for more than the actual sales amount; for example, a \$1.00 item rung on the register as \$10.00. The reverse (under-rings) also occur.

Over-rings and under-rings are to be treated as a reduction or addition to sales recorded on the cash register.

- (3) Charge sales checks have illegible or missing credit card imprints or handwritten customer names. (These are billed as an unidentifiable receivable and subsequently written off to cash register shortage.)

Illegible charge sales checks are considered as worthless or uncollectible accounts. Accordingly, such uncollectible sales qualify as a bad debt deduction. However, any amounts which are subsequently collected should be reported.

- (4) Charge sales checks are lost prior to billing.

Charge sales checks lost prior to billing are considered as uncollectible accounts qualifying as a bad debt deduction.

- (5) Employee or other theft from register.

These amounts are not allowable as a reduction of sales. When money is stolen, there is not a question as to whether or not consideration was received.

- (6) Charge sales checks indicated by sales person as cash and therefore never billed to the customer.

These are considered to be worthless accounts similar to items 3 and 4.

- (7) Counterfeit money received.

Sales paid for by counterfeit money, fraudulent checks or unauthorized charge plates are allowable reduction of sales. However, the reduction is limited to the original sales amount. Losses attributable to counterfeit money or fraudulent checks in excess of the original sale are not allowable.

- (8) Cash register change errors.

Change errors are not to be treated as an adjustment to recorded cash register sales. Such errors are similar to lost or stolen money. The change error occurs after consideration for the merchandise has been received. Any recourse against a customer who has received excessive change would be based on the fact that they have money which belongs to the store. It would not be based on lack of consideration received for the merchandise purchased.

Differences which are claimed as a reduction of cash register sales must be supported by the facts on hand. The analysis of a representative test period should, in fact, substantiate that any one, or a combination of the factors enumerated, does support a reduction in cash register sales in the amounts and to the extent claimed.

PURCHASES SUBJECT TO SALES OR USE TAX**0408.00****GENERAL****0408.05**

The auditor must be alert to distinguish between sales tax and use tax in order to assert the tax liability properly. Generally, the sales tax is the liability of the seller, whereas the use tax is the liability of the purchaser. A retailer who consumes merchandise purchased for resale under a valid resale certificate or any person who consumes merchandise purchased from a retailer, the sale of which is exempt from sales tax, is liable for the use tax on the cost of the property purchased. In the latter case, the purchaser's liability is not extinguished unless they have paid the tax to the State, or to a vendor who is authorized or required to collect the use tax and has issued a receipt to the purchaser.

If a purchaser certifies in writing to a seller that the property purchased will be used in a manner or for a purpose entitling the seller to regard the gross receipts from the sale as exempt from the sales tax and uses the property in some other manner or for some other purpose, the purchaser shall be liable for payment of sales tax as if the purchaser were a retailer making a retail sale of the property at the time of such use and the sales price of the property to the purchaser shall be deemed the gross receipts from such retail sale.

Many consumers neglect to report taxable purchases because a satisfactory method of accumulating these purchases is not used. The auditor should be particularly vigilant in examining purchase orders, purchase invoices, requisitions and journal entries as well as general ledger accounts labeled "Research and Development" and "Promotional" for evidence of use tax. See section 0409.75 for a discussion of the audit procedures to be used for drop shipment transactions.

METHODS OF VERIFICATION**0408.10**

Based on the type of business and the condition of the records, there are three general procedures used in establishing purchases subject to use tax:

- Examination of purchase invoices, requisitions, journal entries and inventory credits
- Examination of debits to selected general ledger accounts and tracing the entries back to the purchase invoices or other documents of original entry
- In some businesses such as small bars and small grocery stores, a reasonable estimate may be used.

EXAMINATION OF PURCHASE INVOICES**0408.15**

Invoices for a representative period, depending on the volume, should be examined and compared with the purchase record to determine that all invoices are on hand. Either all purchases that are considered taxable should be scheduled, or if details of reported amounts are available, the purchases should be traced to the taxpayer's working papers and only the omitted items need be scheduled. A copy of the schedule should then be submitted to the taxpayer for verification. The taxpayer may be able to prove that the questioned items were not subject to the tax or were reported in another quarter. If the results of the test prove the taxpayer is reporting all items correctly, this phase of the examination should be discontinued. If, however, the test indicates improper reporting the test may be expanded, possibly to cover the entire audit period.

After having examined several months' invoices, the auditor should be familiar with the names of vendors who supply the taxpayer with resale merchandise only or those vendors who consistently charge tax on consumable items as well as those vendors who do not charge tax on consumable items. Thereafter, the examination of invoices can be limited to those issued by vendors in the latter category. Frequently the "miscellaneous" file for each letter of an alphabetic file is a source of purchases subject to use tax.

An examination of purchases for capital expenditures should be made in detail only as the transactions are generally few in number with a relatively high unit value. Furthermore, such purchases usually are not made at regular intervals or in consistent amounts.

Wherever possible, estimate purchases of supplies, expendable tools, etc. based on a test period. This is particularly true in types of businesses where the consumable supplies bear a direct relationship to units produced or sold, e.g., coke used in the cupola process for producing steel, advertising material used in sales promotion, grease used in lube jobs, etc.

The monthly amounts of merchandise so consumed can be determined by an examination of several months' purchase invoices. When this method is used, the taxpayer should be consulted and approval secured, if possible. (See Chapters 8 and 9 for discussions regarding purchases subject to use tax in restaurants and grocery stores, respectively.)

In instances where a voucher number system is used for accounts payable and filed in numerical order by years, it will be necessary to control any test, beyond either spot checking or a complete year's examination of invoices, working from the voucher register to the invoices. A dollar volume test as described under section 0405.20 might be used here if it is not practical to make a test from the voucher register. Invoices filed alphabetically by years may be examined (short of spot tests or complete review) by working from the distribution thereof in the purchase journal or check register. That is, specific expense account distributions may be reviewed or tested back from the book of original entry to the invoices. Here, again, as suggested in the foregoing a dollar volume test might be developed.

USE OF FORM BOE-503, "ABC" LETTER PROCEDURE

0408.16

The taxpayer may be able to prove that the questioned items were not subject to tax; or were reported in another reporting period; or the tax was paid by the vendor on their tax return or audit determination. To assist the taxpayer in satisfying their use tax obligation, the Board has developed the Form BOE-503 – ABC Letter Procedure (hereafter called "ABC" Letter). (See Exhibit 8)

The "ABC" Letter procedure utilizes the following form set:

- (1) BOE-503-A, explains the "ABC" Letter procedure
- (2) BOE-503-B, Sample "ABC" Cover Letter
- (3) BOE-503-C, Concerning Property Purchased Without Payment of California Use Tax

When it is appropriate to use the "ABC" Letter process, the auditor will provide the taxpayer with a copy of the BOE-503-A, B, and C. The auditor should discuss the "ABC" Letter process with the taxpayer and explain that a satisfactory response to an "ABC" Letter inquiry alone is not necessarily enough to relieve the taxpayer from payment of the use tax, and that other evidence may be considered in reaching a conclusion. The auditor should also explain that since the "ABC" Letter is not a substitute for a receipt for payment of use tax, additional documentation or information may be required.

A period of four weeks will be allowed for the taxpayer to prepare and send the "ABC" statements and for their vendors to reply. It is recommended that the "ABC" statements be returned directly to the Board. If this is the case, the auditor should provide the taxpayer with return envelopes with the address of his or her district or branch office. Please note, business reply envelopes (no postage necessary) should not be used. If the taxpayer elects to have the "ABC" statements returned to them, the auditor should explain to the taxpayer that the likelihood of having staff contact the vendor or sending an additional mailing is greater.

The taxpayer may customize the "ABC" cover letter (BOE-503-B) by using the text contained therein on their own letterhead, however, the text in the sample letter should be used without additions, deletions, or changes. Any modification to the cover letter must be approved by the auditor's supervisor.

The "ABC" statement (BOE-503-C) must be used as provided by the auditor. The use of a standardized "ABC" statement will reduce any possible controversy over whether the substantiation provided is satisfactory. The auditor should put his or her office designation in the space marked "DMA" and their initials in the space marked "Auditor's Initials," both located at the top right of the "ABC" statement.

The taxpayer's vendor is requested to return the completed "ABC" statement within 10 days. The 10-day requirement is intended to encourage a prompt response from the vendor. If the taxpayer chooses the recommended procedure of having the completed "ABC" statements returned directly to the Board, the taxpayer may add a statement in the letter (BOE-503-B) asking their vendor to send a copy of the completed "ABC" statement to them by fax or mail.

The original "ABC" statement should be sent or faxed to the Board by the taxpayer's vendor. If the completed "ABC" statements are to be sent directly to the taxpayer, the signed original should be examined. If a second "ABC" Letter is necessary, the auditor should establish a reasonable period of time based on the circumstances involved.

Upon receipt of the "ABC" statement, the auditor should verify the information contained therein. For instance, the auditor should verify the permit number, audit periods, determination date, etc. for accuracy. Any inconsistencies should be brought to the taxpayer's attention. Additionally, if the response on the "ABC" statement is Item C, and all other information is correct, the in-state auditor should assess use tax on the California consumer and prepare and send a Form BOE-1164, "Audit Memorandum of Possible Tax Liability" to the Out-of-State District Office along with a copy of the "ABC" statement notifying them that the transaction was assessed against the buyer.

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, 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 OF POSSIBLE TAX LIABILITY****0408.20**

In the examination of purchase invoices, the auditor frequently notices that the California vendor did not charge sales tax on some or all of the invoices issued, and the purchaser did not issue a purchase order marked "for resale" or a resale certificate 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, Form BOE-1164 should be prepared 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 auditor should also 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 Form BOE–1164 for such sales. The form 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 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 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 the authority of the retailer or that of a subsidiary, for the purpose of selling, delivering, installing, assembling or 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 taxable purchases from an unregistered out-of-state vendor without tax, the auditor should advise Out-of-State District Compliance, using Form BOE–1032 (Exhibit 3). If the vendor is registered, the proper form to use is Form BOE–1164 and not Form BOE–1032.

Form BOE–1032 is helpful in the proper registration of out-ofstate vendors who are engaged in business in California. 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 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 make sure the complete address, including the zip code, is noted on Form BOE–1032. 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.

Analysis of purchases from out-of-state retailers may develop information that will lead not only to the registration of out-of-state 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 more attention since their volume of business in California is generally extensive.) Reports on sales made to businesses in the food processing, entertainment, and service 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 may not come to the Board's attention.

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 is not "engaged in business" in the state.

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 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 the responsibility for the payment of tax to the proper authority per Regulation 1685, *Payment of Tax by Purchasers*. 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. Regulation 1686, *Receipts for Tax Paid to Retailers*, lists information required on the receipt.

EXAMINATION OF SELECTED GENERAL LEDGER ACCOUNTS**0408.25**

The verification procedure should include an examination of debits in certain general ledger accounts. This is necessary as invoices covering capital expenditures frequently are not filed with the other purchase invoices. From the documentary reference, it is possible to trace the originating documents. Taxable purchases not previously scheduled on which tax was not added by the vendor, should be scheduled and verification made that the taxpayer is responsible for tax. These items are generally located in the following accounts:

Asset Accounts

Delivery Equipment
 Furniture and Fixtures
 Inter-Company Accounts
 Leasehold Improvements
 Machinery and Equipment
 Nonexpendable Tools
 Work in Progress
 Supplies
 Samples
 Promotional

Expense Accounts

Advertising
 Donations
 Expendable Tools
 Experimental and Exploration
 Manufacturing Expense
 Repairs
 Research and Development

This phase of the examination can be done at the same time these accounts are being examined for additional taxable sales.

The auditor should examine invoices representing purchases of significant taxable additions to fixed asset accounts.

Unsupported debits to the fixed asset accounts should be questioned by the auditor and listed on a subsidiary schedule. The taxpayer should be provided with a copy of this schedule and given a reasonable period of time to obtain support for the items in question before closing the audit. If no support is provided, use tax should be asserted against the taxpayer. When necessary, a Waiver of Limitation, Form BOE-122, should be obtained.

The examination of asset accounts may reveal that the proper amount of use tax has not been paid to the Department of Motor Vehicles on the purchase price of a vehicle. Generally, this occurs in those instances in which (1) the change in ownership was not recorded with the Department of Motor Vehicles; (2) the selling price was substantially different than the measure on which tax was collected by the Department of Motor Vehicles; or (3) the vehicle has special equipment attached which was not included in the measure on which tax was collected by the Department of Motor Vehicles.

In such instances, the use tax is to be asserted against the purchaser. (See the tables in CPPM 830.005 for specific examples of how penalty and interest may apply to use tax due on purchases of vehicles.)

The measure of additional tax is not to be included in Form BOE-414-A, Report of Field Audit, on the seller, even when disclosed by audit of the seller.

In recommending the additional measure against the purchaser, either Form BOE-414-A, Report of Field Audit, or Form BOE-414-B, Field Billing Order, will be used, depending on the extent of the examination of the purchaser's records.

Form BOE-111, Certificate of Vehicle, Mobilehome or Commercial Coach Use Tax Clearance, will be issued by the district office for those vehicles on which tax is recommended by audit or F.B.O. and the change in ownership was not recorded with the Department of Motor Vehicles.

OTHER RECORDS**0408.27**

Other records may be useful in establishing purchases subject to use tax including property tax records such as the Business Property Statement that taxpayers are required to file with their county assessor's office on an annual basis. The statement lists all equipment the taxpayer uses in his or her business along with the purchase price and acquisition date.

CAPITALIZATION OF RESALE INVENTORY**0408.28**

Note: This section does not apply to the capitalization and depreciation of a vehicle. The application of tax to the demonstration and display of vehicles is covered in Regulation 1669.5.

There is a strong presumption that resale merchandise withdrawn from an inventory account, including property used for demonstration and display, capitalized in a fixed asset account and depreciated for income tax purposes is not held for sale in the regular course of business. To overcome this presumption, the taxpayer must provide documentation suitable to the Department that the property has been used solely for exempt demonstration and display purposes while holding it for sale in the regular course of business. In the absence of such evidence, resale merchandise withdrawn from an inventory account, capitalized in a fixed asset account and depreciated for income tax purposes shall be included in the schedule of unreported property subject to tax.

EXAMINATIONS OF JOURNAL ENTRIES AND REQUISITIONS**0408.30**

A retailer may carry a stock of supplies most of which is resold, the balance being self-consumed. All or part of this material may have been purchased for resale. As the supplies are withdrawn from inventory, requisitions may be made by which cost of sales or another expense account is debited and the inventory account is credited.

The auditor should examine these requisitions in the same manner as purchase invoices are examined. If the material was withdrawn from resale (ex-tax) stock and charged to a capital or an expense account, all unreported items not previously scheduled should be listed. If the material was withdrawn from mixed stock, that is tax paid and ex-tax stock, the percentage of ex-tax purchases to total purchases should be computed from a test analysis of purchase invoices. This percentage would then be applied to material charged to taxable accounts.

Commingled fungible goods must be treated differently. In such cases, self-consumed merchandise will be presumed to have been taken from that portion of the stock which was not purchased for resale to the extent such stock is available (See 0408.35).

It may be found, after a test analysis, that all charges to certain accounts are taxable. In that case, the totals of these accounts can be listed from the general ledger. In other cases, it may be determined that all charges, via requisitions, to certain accounts are taxable but the remaining charges are direct from the purchase journal. Taxable withdrawals from inventory, via requisitions, can generally be located in the general journal.

Taxable withdrawals from inventory may also be made without a record being kept. For example, few bar owners list all drinks consumed or given to customers. Where it is discovered unrecorded withdrawals have been made, the auditor should estimate the amount which will have a bearing on tax.

FUNGIBLE GOODS**0408.35**

Sales of fungible goods will be considered to have been made from goods purchased for resale until the amount sold equals the amount so purchased. Conversely, merchandise withdrawn from inventory for self-use will be considered to be taken from stocks of goods not purchased for resale to the extent that such stock is available.

The following examples illustrate the application of this principle where commingled fungible goods both purchased for resale and not so purchased are both sold and self-consumed.

		Total Goods Acquired	Goods Purchased For Resale	Goods Not So Purchased	Additional Measure of Tax
Example 1	Purchases	\$10,000	\$8,000	\$2,000	
	Resold	7,000	7,000	0	0
	Subtotal	\$3,000	\$1,000	\$2,000	
	Own Use	1,000		1,000	0
	Ending Inventory	\$2,000	\$1,000	\$1,000	0
Example 2	Purchases	\$10,000	\$8,000	\$2,000	
	Resold	3,000	3,000	0	
	Subtotal	\$7,000	\$5,000	\$2,000	
	Own Use	4,000	2,000	2,000	\$2,000
	Ending Inventory	\$3,000	\$3,000	- 0 -	
Example 3	Purchases	\$10,000	\$8,000	\$2,000	
	Resold	5,000	5,000	0	
	Subtotal	\$5,000	\$3,000	\$2,000	
	Own Use	3,000	1,000	2,000	\$1,000
	Ending Inventory	\$2,000	\$2,000	- 0 -	

USE OR LOAN OF PROPERTY PURCHASED FOR RESALE**0408.40**

If a purchaser who timely gives a resale certificate or purchases property for the purpose of reselling it makes any storage or use of the property other than retention, demonstration or display while holding it for sale in the regular course of business, the storage or use measured by the purchase price is taxable as of the time the property is first so stored or used. However, sections 6094 and 6244 provide that for property used under the following conditions the measure of the tax is the fair rental value of the property for the period of such other use:

- Loan of property to customers as an accommodation while awaiting delivery of property purchased or leased from the lender, or the loan of property to a customer while the customer's property is being repaired by the lender, provided it is not a loan of property pursuant to a mandatory warranty.

If a specific charge is made for use of the property, this may be used as the measure of tax provided the charge is consistent with the fair rental value.

- Property used *frequently* for purposes of demonstration or display and *used partly for other purposes*.

Property loaned to customers or used by the taxpayer may not be recorded or merely recorded as memorandum entries. The above types of transactions may be disclosed through a discussion with the taxpayer, their employees, or by examining sale invoices or rental agreements.

AUDIT MANUAL

AUDIT OF SALES FOR RESALE **0409.00****GENERAL** **0409.05**

Sales for resale is the most common deduction claimed and the auditor should be familiar with all of the methods used by taxpayers in compiling the amounts reported and the various auditing procedures used to verify those amounts. Whenever feasible, the audit procedure should be adapted to the method used by the taxpayer in reporting, as this makes it easier to reconcile audit findings with reported figures, and usually reduces auditing time. Examination of taxpayer's working papers and a conference with the taxpayer will disclose the method used.

METHODS OF REPORTING REALES **0409.10**

The most common methods used by retailers in compiling data for the claimed sales for resale deduction are:

- To prepare an actual list of deductible items
- To calculate the deduction as described in section 0409.20
- To estimate the deduction

DEDUCTION SUPPORTED BY ACTUAL LISTS **0409.15**

The deduction is supported by lists of nontaxable items which may be prepared in one of the following methods:

- By scheduling each nontaxed invoice
- By recording sales for resale in a separate column in the sales journal
- By preparing adding machine tapes of sales for resale invoices
- By recording sales for resale in the general ledger, and supporting the amounts by journal entries

DEDUCTION CALCULATED **0409.20**

One method frequently used by taxpayers in computing a sales for resale deduction is to determine the residual amount after deducting the sum of taxable sales and other deductions from total sales. In determining this residual amount, the taxpayer may:

- List the total taxable sales and exempt sales other than sales for resale if they are few in number.
- Convert to measure of tax the amount of sales tax reimbursement as recorded in the sales tax accrual account. If no reserve account is maintained, the sales tax collected is usually compiled by running adding machine tapes of the sales tax charged on all sales invoices.
- The formula used in this conversion of tax is tax collected divided by rate of tax ($\text{Tax} / \text{Rate} = \text{Taxable Sales}$).

DEDUCTION ESTIMATED **0409.28**

Where the taxpayer estimates the deduction, there will be no support for the amounts claimed, nor will the basis for the estimate lend itself to ready verification. In these instances, the auditor should use one of the verification procedures outlined below which seems best suited to compile the deduction with a minimum expenditure of audit time.

SELECTION OF THE BASIS FOR THE AUDIT**0409.30**

The extent of audit of sales for resale will depend on the conditions encountered. If the claimed deduction consists of relatively few items so that all transactions can be examined in a reasonable amount of time, the audit should be made in detail. This is particularly true where the unit sale is in a large amount or where the amount of the average unit sale is small with an occasional large sale. If, however, sales for resale are numerous and of a reasonably similar unit value, the verification can and should be made on a test basis. The size of the test will depend on the number of documents necessary to examine.

The periods or number of transactions selected should be representative of the business as a whole. Whenever possible, the test should be selected using a statistical sample. Whether a statistical sample or block sample is selected, a control of sales for the transactions being tested must be established.

In audits of unusually large concerns with relatively few retail sales or audits of concerns using computerized accounting, special procedures may have to be adopted. Because each of these cases presents its own special problems, possible audit methods for such cases are not discussed in this chapter.

The audit procedures used to verify sales for resale may be roughly classified as follows:

- Detailed audit — lists of claimed sales for resale available.
- Detailed audit — lists of claimed sales for resale not available.
- Audit on test basis — (section 0405.20).

DETAILED AUDIT — LIST OF CLAIMED RESALES AVAILABLE**0409.35**

Claimed resales should be summarized by months or by quarters in accordance with the taxpayer's listings. The taxpayer's detailed schedules will be used as a basis for the verification. The steps necessary to making the verification are:

- (a) The sales invoices should be examined to determine that the claimed amounts are included in total sales and that the correct amounts have been scheduled. It should be verified that the amounts claimed do not include nontaxable items (delivery charges, labor, etc.) claimed under some other classification, and that no part of the invoice represents a taxable sale.
- (b) Documentary evidence of the nontaxability of the sales, such as resale certificates, purchase orders, correspondence, or contracts should be examined. Purchase order, correspondence or contracts may, also, support a finding that a claimed sale for resale is taxable notwithstanding the fact that a resale certificate is on file (section 0409.50).
- (c) The nature of transactions and the type and number of items purchased should be scrutinized to determine whether resale certificates (section 0409.55) appear to have been taken in good faith.

All sales which are questioned for any reason should be listed on a subsidiary schedule. A copy of this schedule should be given to the taxpayer as an aid in attempting to support the exempt status of the questioned items. A reasonable period of time should be given the taxpayer to obtain this information before closing the audit. When necessary a Waiver of Limitation, Form BOE-122, should be obtained.

DETAILED AUDIT — LIST OF CLAIMED REALES NOT AVAILABLE**0409.40**

The taxpayer should be requested to prepare a detailed listing of all claimed sales for resale and allowed a reasonable amount of time to do so. When his/her work has been completed, the audit procedure will be the same as set forth in section 0409.35.

EFFECT OF “CONTRA” ITEMS ON DEDUCTIONS FOR SALES FOR REALE 0409.45

Contra items as they relate to the deduction for sales for resale are:

- Sales for resale omitted from total sales and from the claimed sales for resale
- Sales for resale claimed under the heading of some other deduction, such as labor, etc
- Sales of labor, sales in interstate commerce, etc., claimed under the heading of sales for resale

When the audit of all deductions is made on a complete basis or when the audit is made on a taxable sales basis, the final result will not be affected if the deduction is allowed to remain in the classification under which it was claimed. If the audit is made on a test basis with all deductions being audited, it will sometimes be necessary to reclassify deductions under their proper heading to establish a proper base for computation and application of a factor of error.

ACCEPTABLE DOCUMENTARY EVIDENCE TO SUPPORT SALES FOR REALE**0409.50**

A claimed sale for resale should be allowed if it is supported by a resale certificate that is proper in form and is timely taken in good faith from a person who is engaged in the business of selling tangible personal property and who holds a California seller's permit. If the purchaser is not required to hold a permit because the purchaser sells only property of a kind the retail sale of which is not taxable, e.g., food products for human consumption, or because the purchaser makes no sales in this State, an appropriate notation to that effect should be entered in lieu of a seller's permit number on the resale certificate. See Regulation 1667 for exemption certificate requirements. A certificate will be considered timely if it is taken at any time before the seller bills the purchaser for the property, or any time within the seller's normal billing and payment cycle, or any time at or prior to delivery of the property to the purchaser.

Sales to Mexican Merchants for resale are allowable if certain requirements are met. The auditor should insure that the purchaser was the person named on the Mexican Merchant identification card, the card was valid at the time of the sale (cards have expiration dates), and the merchandise purchased for resale related to the special business classification codes on the card. Assistance in verifying Mexican merchants registered under the program and the type of property they are authorized to purchase for resale can be obtained by calling the San Diego District. Additional information about the program is contained in Publication 32.

Any document, such as a letter or purchase order, timely provided by the purchaser to the seller will be regarded as a resale certificate with respect to the sale of the property described in the document if it contains all of the essential elements in Regulation 1668. A signed resale certificate that has been scanned and transmitted electronically or via a facsimile machine (faxed) is acceptable provided that it contains all of the information required by Regulation 1668, is timely and accepted in good faith, and contains the date and time of transmission and telephone number of the sender either on the document itself, or on the proof of transmission such as a copy of the email, or on the standard fax cover sheet.

Documents that qualify as a valid resale certificate include:

1. A purchase order that contains all the elements of a valid resale certificate. Unless a valid qualified resale certificate is on file, the purchase order must contain the phrase “for resale” and all other elements of a valid resale certificate.
2. A valid qualified resale certificate taken timely and in good faith, combined with a purchase order that contains any of the following phrases or similar terminology to indicate that tax or tax reimbursement should not be added to the sales invoice.
 - “for resale”
 - “resale = yes”
 - “taxable = no”
 - “nontaxable”
 - “exempt”

A purchase order where the tax amount is zero (\$0) or is left blank does not indicate that the property is purchased for resale, unless the purchase order includes the phrase “for resale” or any of the terminology described previously to specify that the property purchased is for resale. If each purchase order does not so specify, or is not issued timely within the meaning of Regulation 1668(a), it will be presumed that the property covered by that purchase order was not purchased for resale and that sale is subject to tax.

If the purchase order includes both items to be resold and items to be used, the purchase order must specify which items are purchased for resale and which items are purchased for use. For example, a purchase order issued for raw materials for resale and also for tooling used to process the raw materials should specify that the raw materials are purchased for resale and that the sale of the tooling is subject to tax.

A seller shall retain copies of the purchase orders along with the qualified resale certificates in order to support sales for resale.

3. A letter covering a specific purchase from an out-of-state retailer or from a California purchaser if all the elements of a resale certificate are shown therein.
4. Contracts of sale where all the essential elements of a resale certificate are included. (The auditor should be especially careful to scrutinize transactions where the purchaser claims to be reselling to the U.S. Government by determining the merchandise is actually resold in the form of personal property, title passed to the Government prior to any use by the purchaser, and it is not used in making improvements to real property.)

Other evidence of the validity of a claimed sale for resale may be accepted, such as:

- Personal knowledge of the auditor gained from audits of the vendees or other sources that the purchase was actually made for resale purposes.
- A satisfactory response to a Form BOE-504 (XYZ letter) inquiry (See AM sections 0405.20(j) and 0409.51, and AM Chapter 4 Exhibit 9 for more details).

USE OF BOE-504 — XYZ LETTER PROCEDURE**0409.51**

The auditor must ensure that the taxpayer understands that any of the above other evidence by itself is not the equivalent of a resale certificate timely taken in good faith, and may not relieve the seller of the liability for the tax.

In absence of any valid resale documentation, the auditor may determine that it is appropriate for a seller to use the Form BOE-504 series of forms (hereafter called “XYZ” Letters) procedure to help satisfy their burden of proving that a sale was not at retail even though a valid resale certificate was not obtained or to substantiate a claim that their customer paid the tax directly to the state. Copies of the forms are available on eBOE.

The “XYZ” Letter procedure utilizes the following forms:

- BOE-504-A, explains the “XYZ” Letter procedure
- BOE-504-B, Sample “XYZ” Cover Letter
- BOE-504-C, Statement Concerning Property Purchased Without Payment of California Sales Tax, for use when auditing in-state sellers
- BOE-504-COS, for use when auditing out-of-state sellers
- BOE-504-CLS, for use when questioning sales made to leasing companies
- BOE-504-BPA and BOE-504-CPA, for use when questioning ex-tax sales of special printing aids (also see AM section 1103.30)
- BOE-504-CFS, for use when questioning ex-tax sales of feed, fertilizer, seed or annual plants
- BOE-504-CUS, for use when questioning ex-tax sales made to U.S. Government supply contractors

When it is appropriate to use the “XYZ” Letter process, the auditor will provide the taxpayer with a copy of forms BOE-504-A, B, and C (or -COS, -CLS, -CPA, -CFS or -CUS as appropriate). The auditor should discuss the “XYZ” Letter process with the taxpayer and explain that a response to an “XYZ” Letter inquiry alone is not necessarily enough to support a sale for resale. The auditor should also explain that since the “XYZ” Letter is not a substitute for a timely resale certificate, additional documentation or information may be required. Where the use of “XYZ” Letters is not advisable or appropriate, and the taxpayer insists on using the procedure, the taxpayer must be advised in writing that their customer’s response may not be accepted as verification of an exempt transaction.

A period of four weeks will be allowed for the taxpayer to prepare and send the “XYZ” statements and for the customer to reply. It is recommended that the “XYZ” statements be returned directly to the Board. If this is the case, the auditor should provide the taxpayer with return envelopes with the address of his or her district branch office. If the taxpayer elects to have the “XYZ” statements returned to them, the auditor should explain to the taxpayer that the likelihood of having staff contact the customer or sending an additional mailing is greater.

The taxpayer may customize the “XYZ” cover letter (BOE-504-B or BOE-504-BPA for special printing aids) by using the text contained therein on their own letterhead; however, the text in the sample letter should be used without additions, deletions, or changes. The taxpayer may ask their customers to forward payment of tax reimbursement if the transaction is identified as taxable. The statement should clearly state that the payment of tax be forwarded to the taxpayer and not the Board. All modifications to the cover letter must be approved by the auditor’s supervisor.

The “XYZ” statement (BOE–504–C, COS, CLS, CPA, CFS, or CUS) must be used as provided by the auditor. The use of a standardized “XYZ” statement will reduce any possible controversy over whether the proof provided is satisfactory. When verifying unique types of sales (e.g. printing aids, animal feed, fertilizer, etc.), auditor should provide the specialized forms to the taxpayer. The auditor should put his or her office designation in the space marked “DMA” and their initials in the space marked “Auditor’s Initials,” both located at the top right of the “XYZ” statements.

The taxpayer’s customer is requested to return the completed “XYZ” statement within 10 days. The 10–day requirement is intended to encourage a prompt response from the customer. If the taxpayer chooses the recommended procedure of having the completed “XYZ” statements sent directly to the Board, the taxpayer may add a statement in the letter (BOE–504–B) asking their customer to send a copy of the completed “XYZ” statement to them by fax or mail. The original “XYZ” statement, however, must either be sent or faxed to the Board by the taxpayer’s customer. If the completed “XYZ” statements are to be sent directly to the taxpayer, only a signed original will be accepted.

If a second “XYZ” Letter is necessary, the auditor should establish a reasonable period of time based on the circumstances involved.

As explained in section 0302.80, XYZ responses are part of the audit working papers and should be included as a subsidiary schedule to the resale examination schedule.

XYZ non-responses should not automatically be considered errors or non-errors. When XYZ responses are not returned, audit staff should make every effort, if not already done, to determine the taxability of the questioned sale by alternative methods. Such methods could include, but are not limited to:

- Examine the customer’s seller’s permit registration to determine whether or not the purchaser had a permit at the time of purchase, the type of business, reported sales, etc.
- Review the quantity and type of items sold – for resale or consumption.
- Review a subsequent resale certificate (prior to the start of the audit) but for similar purchases.
- Examine other types of items sold to the customer.
- Contact the customer by telephone to determine the true nature of the sale. If the customer indicates that the sale was for resale, a copy of the XYZ request letter should be faxed to the customer for immediate response. This XYZ response will be subject to the same verification as any other XYZ response.
- Accept or deny based on personal knowledge of the auditor gained from prior audits or other sources.

There are occasions when the taxpayer is unable to obtain an XYZ letter response because the customer is no longer in business due to a bankruptcy or other reason. In this situation only (not where there is just a change in ownership, such as a change in partners or from a sole proprietorship to partnership/corporation in which the previous owner continues the business under the new ownership), the sale will be considered a sale for resale if the property purchased by the customer is consistent with the type of sales the business makes. The auditor must verify file information regarding the close-out or bankruptcy of the business, as well as the type of business operations of the customer to ensure that the situation meets these specific requirements.

In all other situations, if the sale appears to be of a type that could be consumed, the taxpayer is unable to obtain a proper XYZ letter response, and the auditor is unable to determine the exempt status of the sale by alternative means, the non-response should be considered an error.

WHEN GOOD FAITH OF SELLER IS QUESTIONED**0409.55**

A resale certificate relieves the seller from liability for sales tax and the duty of collecting the use tax if the seller timely takes a certificate in good faith from a person who is engaged in the business of selling tangible personal property and who holds a California seller's permit.

A seller will be presumed to have taken a resale certificate in good faith in the absence of evidence to the contrary. If the purchaser insists that property of a kind not normally resold in their business is being purchased for resale, the seller should require a resale certificate containing a statement that the specific property is being purchased for resale in the regular course of business. If the good faith of the seller is in question, the burden of proof will rest with the Board.

The auditor has the responsibility of examining the resale certificates. The auditor must be reasonable and fair-minded and must use good judgment in determining whether the certificate is sufficient in content and whether the seller acted in good faith in accepting the certificate.

Examining the resale certificates, which give general descriptions of the purchaser's business, and invoices of sales for resale, which disclose the type of property sold, requires the auditor to judge whether items shown on the invoices are properly included within the general description.

In making a decision, the auditor should be guided by the test of reasonableness. The auditor should question sales for resale that do not meet such a test or if the seller knows beyond a reasonable doubt that the property was bought for the purchaser's own use. Examples of transactions which should be questioned include:

- Sale of furniture or fixtures to a grocery store
- Sale of janitorial supplies to a restaurant
- Sale of building materials to a contractor where the terms of sale specify delivery to the job site
- Sale of cleaning solvent to a repairman
- Tools sold by a parts house to a repair shop

When the seller insists a particular item, not reasonably included in the description, was actually sold for resale, the seller should be required to secure a statement from the purchaser covering the specific item in question.

PURCHASE ORDERS AND RESALE CERTIFICATES**0409.60**

A resale certificate may be qualified by specific instructions on the purchase order. A purchaser who issued a blanket resale certificate to a supplier may specify on a purchase order that the property to be purchased is taxable. Purchase order files should be examined when doubtful situations arise. However, under such circumstances, the purchaser will bear the burden of establishing either that the purchase order was received by the seller or that tax was paid to the seller.

The seller should obtain a resale certificate qualified by special instructions, i.e., one that states "see purchase order," when a purchaser wishes to designate on each purchase order that the property is for resale. Each purchase order must specify whether the property covered by the order is purchased for resale or whether tax applies to the order. Refer to AM section 0409.50, item #2.

MISUSE OF RESALE CERTIFICATE 0409.62

When resales are examined during the course of an audit, particular attention should be paid to transactions that may involve a misuse of a resale certificate. A misuse occurs when the purchaser is not actively engaged in business as a seller or the purchaser knows at the time of purchase that the property is not going to be resold in the regular course of business. Specific situations that indicate the purchaser has made a misuse are when:

- 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 purchaser in the regular course of business.

When a misuse occurs, the purchaser will be pursued for the tax and appropriate penalty (Chapter 5).

A resale certificate which was taken timely and appears to be valid on its face will relieve the seller of the tax liability if the certificate is taken in good faith. For audit purposes, "valid on its face" means that the resale certificate contains the five essential elements described in Regulation 1668, even if one or more of the elements are false. If, however, it is found 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. Questioned sales for resale which represent defective certificates accepted in good faith should be excluded from the sample and the computation of the percentage of error.

TAX ASSESSED ON PURCHASER**0409.63**

Whenever a purchase from a California seller is assessed tax because the purchaser issued a resale certificate to the seller, which the seller accepted in good faith, *a copy of this certificate should be obtained from the seller at the time of audit and included in the audit working papers of the purchaser's audit.* When contacting the seller, the auditor may not inform the seller that the auditor is reviewing the purchaser's records. Instead, the auditor is only allowed to inform the seller that he or she is only verifying whether the seller has a copy of the purchaser's resale certificate on file, and if so, to request a copy of the certificate.

Because the issuance of a resale certificate shifts the tax from the seller to the purchaser, it is imperative that a copy of the resale certificate be obtained while the auditor is reviewing the purchaser's records. A verbal comment by the purchaser that a resale certificate was given to the seller is insufficient. Often customers will indicate concurrence when the audit is completed but change their mind when the Notice of Determination is received and contend that no such certificate was issued and the incidence of tax should be on the California seller. Without written evidence to refute this claim, the Board's position cannot be sustained.

TAX BILLED BY VENDOR BUT DELETED BY PURCHASER**0409.65**

If the seller does not timely obtain a resale certificate, the fact that the purchaser deletes the tax or tax reimbursement from the seller's billing, provides his/her seller's permit number to the seller, or informs the seller that the transaction is "not taxable" does not relieve the seller from liability for the tax nor from the burden of proving the sale was for resale.

VERIFICATION OF PAYMENT OF USE TAX BY PURCHASER**0409.70**

At the time of an audit of a vendor, the vendor may contend that a purchaser-consumer has paid tax on a transaction on which the vendor failed to collect use tax. In these cases, the vendor should be given an opportunity to establish that tax was paid by obtaining a statement from the purchaser that:

- Use tax was declared on a specific return filed by the purchaser, or
- Use tax was paid as a result of a determination made after audit by the Board. In making this statement, the purchaser must establish that the specific item was included in the audit or that the item was of the kind and monetary size included in a percentage of error applied throughout the audit period.

See sections 0405.20 (j) and 0409.51 when XYZ letter inquiries are involved in audit test sample(s).

DROP SHIPMENTS**0409.75**

The following audit procedures should be used when examining drop shipment transactions.

Sales and Use Tax Transactions:

The auditor should determine if the drop shipper's customer (the "true retailer") holds a California seller's permit or a Certificate of Registration – Use Tax. If the true retailer holds such a permit, the transaction should be allowed as a sale for resale in the audit of the drop shipper.

If the true retailer is not registered with the Board, but the auditor determines that the true retailer is, in fact, engaged in business in this state, the transaction should be allowed as a sale for resale in the audit of the drop shipper. The auditor should then notify the appropriate district office of the facts showing that the true retailer is engaged in business in California.

Use Tax Transactions:

Drop shipments made from inventories located outside California by drop shippers engaged in business in this state, pursuant to retail sales made by retailers not engaged in business in this state, are subject to use tax. The auditor should determine whether the consumer in California to whom the property was drop shipped holds a valid seller's permit, consumer use tax permit, Certificate of Registration – Use Tax, or use tax direct payment permit. If the consumer is registered with the Board, and the transaction is subject to use tax, the sale should be eliminated from the audit of the drop shipper. The auditor should then immediately notify the appropriate district office of the potential liability against the California consumer.

AUDIT MANUAL

AUDIT OF SALES TO THE U. S. GOVERNMENT**0410.00****GENERAL****0410.05**

The details covering sales to the United States Government are contained in Regulations 1521, 1614, 1616 and 1618. These regulations may be summarized as follows:

- (a) Sales tax does not apply to sales to:
 - The United States or its unincorporated agencies and instrumentalities.
 - Any incorporated agency or instrumentality of the United States wholly owned by either the United States, or by a corporation wholly owned by the United States.
 - The American National Red Cross, its chapters and branches.
 - Incorporated federal instrumentalities not wholly owned by the United States, unless federal law permits taxing the instrumentality. Examples of incorporated federal instrumentalities exempt from tax are federal reserve banks, federal credit unions, federal land banks, and federal home loan banks.
- (b) Use tax does not apply to the storage, use, or other consumption of tangible personal property by agencies or instrumentalities of the United States unless federal law permits taxing the agency or instrumentality.
- (c) Neither sales nor use tax applies to sales of machinery and equipment to United States construction contractors or subcontractors, provided title to the property passes to the United States before the contractor makes any use of it. Such sales are sales for resale, and the purchasing contractor may issue a resale certificate. A contractor who uses the machinery or equipment before title passes to the United States is the consumer of property, and either sales tax or use tax applies with respect to the sale to or the use by the contractor. The application of tax to consumable supplies and overhead materials on United States Government Supply Contracts (Regulation 1618) is covered in section 0411.00.
- (d) Generally, either the sales tax or the use tax applies with respect to sales of tangible personal property (including materials, fixtures, supplies, and equipment used to perform the construction contract) to United States construction contractors for use in the performance of such contracts for the construction of improvements on or to real property in this state (Regulation 1521).
- (e) Tax does not apply to the sale of items to a person insured pursuant to Part A of the Medicare Act as such sales are considered exempt sales to the United States (Regulation 1614).

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, Form BOE-1164 (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 under the current program called "GSA SmartPay." Credit Cards under this program are issued by Citibank, JPMorgan Chase, 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 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 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 number 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 Visa 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 Visa card and the other is a MasterCard. The Visa cards contain 16–digit account numbers that start with the prefixes 4486 or 4614. 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 Visa 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 start 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.

AUDIT MANUAL

UNITED STATES GOVERNMENT SUPPLY CONTRACTS**0411.00****GENERAL****0411.05**

If title to tangible personal property used in performance of a United States Government supply contract passes to the U.S. Government prior to its use by the contractor, then the sale to the contractor of that property is a valid sale for resale, and the sale by the contractor is exempt under section 6381 of the Revenue and Taxation Code. The provisions of Regulation 1618 together with the title provisions in each individual supply contract determine the application of sales or use tax to consumable supplies and overhead materials purchased for use on the contract. The decisions in the cases cited in this section did not change the law, but did change the interpretation of existing law.

The purpose of this section is to discuss the guidelines to be used in determining title passage and the resulting application of tax to property purchased by contractors for use in fulfilling the requirements of supply contracts with the U. S. Government. If there are no clauses in a contract which accelerate the passage of title to the U.S. Government, title to the property does not pass prior to use by the contractor. As an aid to understanding this discussion, applicable sections of the current Federal Acquisition Regulations (FAR) have been included as Exhibit 10 (A through F). The decisions in this section are based on these standard FAR clauses.

Prior to April 1, 1984 (the effective date of FAR), each federal agency had its own procurement regulations. Creation of the FAR in 1984 was an attempt to provide one set of procurement regulations which would apply to all governmental agencies. The Office of Federal Procurement Policy (OFPP), the office responsible for creating the FAR, regarded the FAR as a consolidation and simplification of existing agency regulations and not as a new set of regulations. Supplements issued by each agency were meant to deal with procurement situations peculiar to that agency and to provide necessary agency implementation procedures. Agency FAR supplements have, however, come to supercede the FAR when they conflict. For example, the FAR appears to permit contractors to purchase canned software for resale to the United States. The Department of Defense FAR Supplement (DFARS) does not.

FAR's are revised periodically and, therefore, in order to determine the tax application to a specific contract, the actual title clauses of that contract must be examined. Each contract must be examined for any modified clauses which may alter the application of tax. Additionally, agency supplements must be consulted to determine if any deviation from the FAR occurred regarding title passage.

Tangible personal property sold to or used by contractors in the performance of a contract with the United States Government to improve real property is not addressed in this section. The provisions of Regulation 1521 continue to govern the application of tax to such sales or use of tangible personal property.

TITLE CLAUSES**0411.10**

The courts ruled in *Lockheed Aircraft Corporation v. State Board of Equalization and Aerojet-General Corporation v. State Board of Equalization* (May 1978) and in *Aerospace Corporation v. State Board of Equalization* (March 1990) that, for purposes of the Sales and Use Tax Law, title to tangible personal property used in the performance of federal contracts passes to the government in accordance with the terms of the title clauses of each contract. Use of such property after title passes to the government is not subject to the use tax.

The title provisions incorporated into a contract with the United States Government determine the time of sale of the property to the United States and govern the taxability of purchases of the property by the contractor. Each contract must be examined for appropriate title clauses to determine if title to tangible personal property passes to the United States prior to use by the contractor.

If classified contracts are encountered, documentation must be supplied by the contractor to support the claim that certain title clauses are contained in questioned contracts. Acceptable documentation includes copies of those pages of the contract containing the appropriate title clauses which may be identified by number to the questioned contract. Normally, verbal statements will not be considered acceptable documentation.

The guidelines in this section apply when the Government enters into a contract *other than* for the purpose of conducting research at nonprofit institutions of higher education or at nonprofit organizations whose primary purpose is the conduct of scientific research. If such contracts are encountered, special considerations regarding passage of title must be considered as noted in the Alternate II for paragraph (c) of FAR 52.245-2 for fixed price contracts or in the Alternate I for paragraph (c) of FAR 52.245-5 for cost reimbursement contracts.

The title provisions of a contract are effective for California sales and use tax purposes notwithstanding the fact that they may be incorporated principally for the purpose of securing the interest of the United States.

FIXED PRICE CONTRACTS**0411.15****General**

The combination of the following clauses incorporated into fixed price contracts will determine when title passes to the United States and will govern the taxability of purchases by the contractor. In examining each contract, it is important to observe whether the following clauses are included in the contract:

“Progress Payments” clause, FAR 52.232-16 (Exhibit 10B) — Indirect (“overhead”) costs

“Government Property” clause, FAR 52.245-2 (Exhibit 10C) — Direct costs

Amended in July 1985 to add an alternate paragraph (c) to be used in research contracts with certain nonprofit organizations. Amended effective December 29, 1989 to delete special tooling from title paragraph (c) and to provide specifically that special tooling accountable to the contract is not subject to the provisions of this clause.

“Special Tooling” clause, FAR 52.245-17 (Exhibit 10E)

This is not a title clause and was amended in December 1989 to add paragraph (b) to clarify that the Government only retains an option to take title to all special tooling covered by the contract.

Special Tooling

The amendments to the title clauses affect the application of the tax to purchases by the contractor of special tooling other than tooling for which the contractor will be reimbursed as an item of direct cost under the contract. Each contract must be examined to determine which version of these clauses, if any, are included or if custom clauses are inserted which pass title to special tooling.

The Progress Payments clause passes title only to that special tooling to which the government will acquire title under another clause in the contract. Therefore, if a Progress Payments clause is present in a contract, purchases of special tooling will not be subject to tax only if this clause is used in combination with another clause which specifically passes title to the special tooling.

The following tax consequences will result from the various combinations of the FAR clauses for special tooling:

12-29-89 to present:

As of 12-29-89, the Government Property clause does not pass title to special tooling. If this is the only title clause present, tax will apply to purchases of special tooling by the contractor.

Special Test Equipment

If a contract contains the Government Property clause, title to special test equipment will pass to the government when the equipment's use in performing the contract begins or when payment is made to the vendor, whichever occurs first. For special test equipment, the Progress Payments clause passes title only to that special test equipment to which the government will acquire title under another clause in the contract.

Therefore, purchases of special test equipment will not be taxable only if a Government Property clause is present or a Progress Payments clause is present in combination with another clause which specifically passes title to special test equipment.

Consumable Supplies

Direct Consumables

Direct consumable supplies are those supplies which are consumed in the performance of a contract and are directly identified with a particular final cost objective. The term consists of those supply items the actual cost of which is charged as a direct item of cost to the contract.

Under a fixed price contract, title to direct consumable supplies does not pass to the United States when the Government Property clause is the only title clause present unless the contract contains an entitlement clause for such supplies as stipulated in FAR 52.245-2(c) (4). Consequently, if the Government Property clause is the only title clause in the contract, the purchase or use of "direct consumable supplies" by the contractor will be subject to tax.

When the Progress Payments clause is present in a fixed price contract, title to "direct consumable supplies" vests in the United States as provided in FAR 52.232-16(d), i.e., upon the date of the contract for property which was purchased or produced before that date, and for other property, upon the date it is or should have been allocable to the contract.

Indirect Consumables

Indirect consumable supplies (overhead materials) are supplies consumed in the performance of a contract, the cost of which is charged to an overhead expense account and then allocated to various contracts based on generally accepted accounting principles.

The Government Property clause does not pass title to indirect supplies. If the Progress Payments clause is present in a fixed price contract, title to “overhead materials” which are allocable to the contract is passed to the United States upon acquisition, production, or allocation. However, in order to support the tax exempt status of the property, it becomes a matter of proof by the contractor that title passes to the United States prior to any use of the property by the contractor and that the property is used on an appropriate qualifying contract.

If the property is charged to overhead expense accounts which are later allocated to various cost centers or jobs, title to the property will be assumed to pass to the United States prior to use of the property by the contractor if the contractor allocates the overhead materials among the various commercial and qualifying and non-qualifying government contracts by means of a reasonable system of allocation which conforms to governing federal regulations and generally accepted accounting principles.

In the Aerospace Corporation case, the court found that an allocation based on direct labor hours incurred on the contract was acceptable. There is no requirement that the contractor physically identify the specific materials through means of a requisitioning system. If the contractor has an acceptable system for allocating these costs, the overhead items should be treated as sold to the United States prior to any use by the contractor and the purchase or use of such items is not taxable.

“Overhead materials” includes accounts in cost accumulation pools which are allocable to a U.S. Government contract(s), e.g., independent research and development, bidding and proposal and other service centers. These pool costs are not taxable only if a qualifying U. S. Government contract was in existence at the time of use and such costs were allocated to such contracts. For example, bid and proposal expenses will be subject to tax if they are incurred at a time when no qualifying government contract was in existence even though the contractor is awarded the contract and such costs are subsequently allocated to it.

COST REIMBURSEMENT CONTRACTS

0411.20

The title provisions incorporated into cost reimbursement contracts will determine the time of sale to the United States and will govern the taxability of purchases by the contractor. There typically is only one title clause (Government Property clause FAR 52.245–5) incorporated into a cost reimbursement contract. (See Exhibit 10D.) This clause merely accelerates passage of title, and it is not mandatory that it be included in all cost reimbursement contracts. Each cost reimbursement contract must be examined to determine if an actual title clause is present.

Generally, title to property purchased by the contractor, the cost of which the contractor is to be reimbursed as a direct item of cost under the contract, will pass to or vest in the United States upon delivery of the property by the vendor. Title to other property, the cost of which is reimbursable to the contractor under the contract, will pass to or vest in the United States Government upon:

- issuance of the property for use in the performance of the contract,
- commencement of processing or use of such property in the performance of the contract, or
- reimbursement of the cost thereof by the United States Government,

whichever occurs first. However, proof that one of these three events occurs and that title passes to or vests in the United States prior to any use by the contractor must be provided by the contractor to support the tax exempt status of the property.

Special Tooling and Test Equipment

Special tooling and special test equipment are normally identified in a cost reimbursement contract as direct items of cost for which the contractor is to be reimbursed. Consequently, in accordance with the Government Property clause (FAR 52.245-5), title to such property vests in the United States upon delivery by the vendor to the contractor and all purchases of such property by the contractor are not taxable.

Consumable Supplies

As discussed in section 0411.15 under fixed price contracts, there are two classes of consumable supplies, "direct" and "indirect" (overhead materials). These terms are defined in the previous discussion of consumable supplies under fixed price contracts.

In accordance with Government Property clause 52.245-5, title to "direct consumable supplies" vests in the United States upon delivery by the vendor to the contractor and all purchases of such property by the contractor are not taxable.

Title to "overhead materials" normally passes to or vests in the United States upon the occurrence of one of the three events discussed above, i.e., issuance of the property for use in performing the contract, commencement of processing or use of the property in performing the contract, or reimbursement of the cost of the property by the United States. However, in order to support the tax exempt status of the property, it becomes a matter of proof by the contractor that one of these three events occurred prior to any use of the property by the contractor.

As discussed previously under fixed price contracts, title to the overhead materials allocated to qualifying government contracts, i.e., contracts with appropriate title clauses, will be assumed to pass to the United States prior to use by the contractor if the contractor allocates the materials among its various contracts by means of a reasonable system of allocation which conforms to governing federal regulations and generally accepted accounting principles.

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 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 for communication with the Secretary of Defense to ascertain the Department's position with respect to the specific contract.

AUDIT OF CASH DISCOUNTS**0412.00****GENERAL****0412.05**

There are several methods of compiling a deduction for cash discounts depending primarily upon the accounting methods in use and the sales policy of the taxpayer. As the deduction is limited to cash discounts actually taken on taxable sales, the problem is to separate the discounts taken on taxable sales from those taken on nontaxable sales. The verification should be made only after total sales and other deductions have been verified, as any change made by the auditor in the taxpayer's classification of taxable and nontaxable sales will affect the deduction for cash discounts. Methods of reporting may be summarized as follows:

- Actual discounts taken on taxable sales
- Percentage of total discounts taken based on ratio of taxable sales to total sales
- Composite percentage of taxable sales
- Cost of trading stamps issued on taxable sales

ACTUAL CASH DISCOUNTS TAKEN ON TAXABLE SALES**0412.10**

The taxpayer's working papers should be examined to determine how the deduction was compiled. If an actual listing of the sales invoices on which the discounts were allowed is available, the auditor can verify the deduction in detail by reference to the sales invoices and the cash receipts record. Usually the sales are too numerous for listing and the cash discounts are summarized by months from the "cash discounts" column in the cash receipts records. In those cases, the audit should be based on a test period. If other deductions were verified on a test basis, the same periods should be used in whole or in part to test this deduction. This will prevent further work in verifying the exempt status of additional transactions outside the test periods used in verifying the other deductions. Each cash discount shown by the cash receipts records should be compared with the sales invoice to which it pertains. Auditors should satisfy themselves that each discount allowed passes the following tests:

- That the discount was actually taken by the purchaser
- That the difference between the invoice price and cash received is actually a cash discount
- That the discount applies to a taxable sale
- That the cost of trading stamps has been reduced by any "dividends" or rebates received from the stamp company based on purchases of stamps
- That the discount was computed so as to reduce the amount of sales tax reimbursement initially charged the customer on the gross taxable sales

When there is no indication that the discount was computed on the selling price exclusive of sales tax reimbursement, it will be considered that the discount was allowed on the total sales price including sales tax reimbursement. This is usually the case with unit or lump-sum discounts. When there is evidence that the discount was computed by applying a percentage to the selling price exclusive of sales tax reimbursement, the discount will not be allowed as a deduction since excess tax reimbursement has been retained by the retailer.

If a taxpayer has not claimed a deduction for cash discounts, credit or refund should be recommended in an audit only if the taxpayer refunds to the customer any excess tax reimbursement which results from the method of computing the cash discount.

COMPOSITE PERCENTAGE OF DEDUCTIONS TAKEN

0412.15

Some companies allow cash discounts on different bases to various classes of customers. For instance, the discount rate may be based on sales volume or on different types of merchandise sold. Under these conditions, a composite percentage can be computed and used. A representative test period should be selected and the taxpayer be requested to analyze all cash discounts taken on taxable sales by scheduling the discounts allowed and the related taxable sales for the period. The percentage will then be computed in accordance with the following example:

Total discounts allowed on taxable sales.....	\$1,560
Total taxable sales on which discounts apply	\$100,000
Average discount rate (\$1,560/\$100,000) or	1.56 %

This rate can then be applied to quarterly taxable sales (excluding purchases subject to use tax) for the entire audit period.

PERCENTAGE OF TOTAL DISCOUNTS TAKEN

0412.20

Theoretically, if all customers took the cash discount allowed and if the same rate of discount were applicable to all sales, the cash discount deduction could be computed by determining the ratio that taxable sales bore to total sales (excluding purchases subject to use tax) applied to total discounts allowed. This may be expressed as follows:

$$\text{Allowable Discounts} = \frac{\text{Taxable Sales}}{\text{Total Sales} + \text{Tax}} \times \text{Discounts Taken}$$

However, in many instances, it will be found that a large proportion of the discounts are taken by large purchasers who buy for resale. Thus, the use of the above formula would produce an inaccurate result. In these cases, the auditor should determine the ratio that discounts taken on taxable sales bear to total discounts taken for one or two test periods. This percentage would then be applied to total discounts taken each quarter of the audit period:

$$\text{Allowable Discounts} = \frac{\text{Discounts Taken on Taxable Sales} - \text{Tax}}{\text{Total Discounts Taken}} \times \text{Discounts Taken}$$

The total discounts taken can be transcribed from the general ledger account after the auditor has satisfied himself/herself the account represents discounts allowed only and does not include any bad debts on nondeductible items.

TRADING STAMPS**0412.25**

The cost of trading stamps may be taken as a deduction in the same manner as cash discounts if the taxpayer complies with either of the procedures which follow:

- Adjust the price on which tax reimbursement is computed so it will correspond to the price upon which the retailer computes the tax paid by him to the State.

For example, a retailer makes a sale for \$100 plus \$7.25 tax reimbursement, gives trading stamps which cost \$3 on the ex-tax selling price of \$100 and takes a deduction of \$3 as a cash discount. He reports sales of \$97 and pays \$7.03 (7.25% of \$97). Collection of excessive sales tax reimbursement of 22 cents resulted from the transaction. The taxpayer should have reported sales of \$100 since tax reimbursement was collected on that amount.

- Consider the price which determines the number of stamps to be given a customer as the total amount (including sales tax) paid by the customer.

For example, if one stamp is given for each 10 cents of purchase price and the total purchase price is \$10.73 (\$10.00 plus \$.73 sales tax), give 107 stamps to the customer rather than 100.

SALES PROMOTION PLANS**0412.30**

From time to time retailers introduce various promotional plans, some of which may qualify as allowable cash discounts. Such plans must be individually analyzed to determine their status for sales tax purposes.

SALES TAX INCLUDED IN CASH DISCOUNTS**0412.35**

If the cash discount taken by the purchaser is allowed on both taxable and nontaxable items (sales tax, installation/repair labor, cartage, etc.), the latter items must be eliminated before computing the deduction. In most instances, this nontaxable element will be limited to sales tax and may be excluded after the gross discount has been computed. This can be accomplished by multiplying the discount by a factor which will reduce the gross discount to the allowable discount. The factor is derived using the following formula:

$$\text{Factor} = 1.00 - \frac{\text{Tax Rate}}{1 + \text{Tax Rate}}$$

For example, if tax has been included in the discounts at the rate of 7.25%, then the factor will be .9324, computed as follows:

$$\text{Factor} = 1.00 - \frac{.0825}{1.00 + .0825} = .9237876$$

AUDIT MANUAL

AUDIT OF RETURNED MERCHANDISE**0413.00****GENERAL****0413.05**

A deduction for returned merchandise must meet the requirements of Regulation 1655. Actual returns of taxable sales are deductible if the following conditions are met:

- The original sale is included in reported taxable sales.
- The full sales price, including sales tax, is refunded either in cash or credit. For purposes of the returned merchandise deduction, “full sales price” is construed to include only amounts required to be included in the measure of tax under sections 6011 and 6012, plus any sales tax added. For example, transportation charges not subject to sales tax need not be refunded in order to claim the returned merchandise deduction (section 0413.25).
- The customer in order to obtain the refund or credit is not required to purchase other property at a price greater than the amount charged for the property returned.

Refund or credit of the entire amount is deemed to be given when the purchase price and sales tax, less rehandling and restocking costs, if any, are refunded or credited to the customer (section 0413.25).

Credit for returned merchandise cannot be allowed if the retailer sets up a credit in the books but fails to give written notification to the customer that the credit is available.

METHODS OF CLAIMING THE DEDUCTION**0413.10**

Merchandise returns are generally entered in the taxpayer’s books in one of the following ways:

- As debits to an account in the general ledger, and claimed as a deduction on the sales tax return. The deduction, when handled in this manner, should be audited in the same way as any other deduction.
- As debit entries in the sales journal (therefore, a reduction in sales) with no deduction being shown on the sales tax returns. When this procedure is followed the verification of the deduction should be made in conjunction with the audit of total sales.

AUDITING PROCEDURE — DEDUCTION CLAIMED**0413.15**

The original documents covering returned merchandise usually consist of credit memoranda which, together with the original sales invoices, are the basis of the credit. Occasionally, an auditor will encounter a situation where no credit memoranda are issued, the taxpayer merely marking on the original invoices or in the sales journal the words “canceled” or “returned.” Such returns or cancellations should not be allowed unless the taxpayer can furnish documentary evidence of returns actually made and meeting the conditions listed in 0413.05. All nontaxable elements of the sale must be eliminated. The claimed deduction can be audited on a complete basis or a test basis, depending on the frequency of returns and the amounts involved.

AUDITING PROCEDURE — DEDUCTION NETTED FROM SALES**0413.20**

When returned merchandise is “netted” from total sales (0413.10), a separate verification of the returns cannot be made as there is no control of the recorded or netted amounts. The verification must therefore be combined with the examination of total sales, all credit memoranda being examined at the time the sales tickets are examined. All netted items not meeting the requirements listed in 0413.05 are to be treated as additional taxable sales not reported and may be combined with unreported or unrecorded sales as a basis for computing an understatement of taxable sales.

REHANDLING AND RESTOCKING CHARGES

0413.25

There are two methods of compiling the cost of rehandling and restocking returned merchandise. The retailer may use:

- (a) The actual cost of rehandling and restocking the returned merchandise. The cost may include, but is not limited to the retailer’s direct costs of the following:
 - Inspection of the merchandise after the request has been made for its return
 - Issuance of authorization for return of the merchandise after the request has been made for its return
 - Freight or delivery charge for shipment of the merchandise from the customer to the retailer
 - Returning the merchandise to stock, and
 - Direct “paper work” involved in the return of merchandise such as preparation of credit memos, accounts receivable corrections, inventory record adjustments, etc., to the extent that it is possible to determine these costs.
- (b) A percentage of the sales price based on the average cost of rehandling and restocking returned merchandise.

The percentage must be based on the average of the actual costs of rehandling and restocking the returned merchandise for the entire previously completed accounting cycle (normally one year). The percentage is computed by dividing the total allowable rehandling and restocking costs incurred in the previous accounting cycle by the total sales price (excluding sales tax) of the merchandise returned during that period. Retailers choosing the percentage of sales method may not:

- Use industry-wide averages
- Use actual cost during any accounting cycle in which an election was made to use the percentage method.

Regardless of which of the two methods is used, only the actual cost of rehandling and restocking returned merchandise is allowable. The taxpayer must maintain adequate records to support how the charge for restocking and rehandling was determined. If the taxpayer incorrectly computes the percentage and accordingly charges a greater, incorrect restocking charge for the entire subsequent year, only those transactions where the actual restocking costs on any specific transaction are equal to or greater than the erroneous percentage claimed may be allowed.

Delivery charges and other charges that are subject to tax as a part of the “gross receipts” must be included in the total sales price when computing the applicable percentage for rehandling and restocking. The computed percentage is applied to the total sales price (excluding sales tax) of merchandise subsequently returned to arrive at the allowable rehandling and restocking charges for sales and use tax purposes. The refund or credit should be computed in the following manner:

Price of merchandise returned	\$100.00
Sales tax @ 7.25%.....	<u>\$7.25</u>
Total	\$107.25
Restocking and rehandling charge @ 10% (\$100 x .10).....	\$10.00
Amount refunded or credited	<u>\$97.25</u>

RETURN OF TAX REIMBURSEMENT

0413.26

If the retailer separately computes the sales tax refund or credit at an amount less than the sales tax on the original transaction, the difference between the sales tax collected and the sales tax refunded is regarded as excess tax reimbursement and should be handled in accordance with section 0417.00.

EXAMINATION OF ACCOUNTS RECEIVABLE

0413.30

The auditor should examine a sufficient number of individual customers' accounts to satisfy themselves that the credit memoranda on file actually represent bona fide credits of the original sales price plus tax. Some retailers issue a credit memo in full but make a service charge or some charge other than a restocking or rehandling charge to the customer. If this condition is discovered, the auditor should disallow the deduction.

It will be noted that Regulation 1655 states in part, "...the full sales price,...is refunded in cash or credit..."

Where the retailer has issued a credit memo and notified the customer in writing at the last known address that a bona fide credit for the full sales price including sales tax is available and the customer's account is so credited, the deduction is allowable. This will be true even though the customer does not utilize the credit and after a reasonable period of time the retailer transfers the unused credit to miscellaneous income or some other income account.

DEFECTIVE MERCHANDISE

0413.35

When defective merchandise is returned to the seller, under conditions not meeting the requirements of Regulation 1655 (0413.05), a deduction may be taken only for the amount credited or refunded because of the defective condition of the merchandise. No deduction can be allowed for the amount refunded or credited because of the return of the merchandise. Accordingly, where the returned defective merchandise has some value, the amount refunded or credited to the customer must be reduced by the value of the merchandise in its defective condition.

PRICE ADJUSTMENTS

0413.40

Occasionally, the auditor will encounter situations where amounts claimed as returned merchandise represent price adjustments on merchandise actually retained by the customer. For example, a customer is not entirely satisfied with the merchandise and wishes to return it. The seller, not wanting to restock the merchandise will prevail upon the customer to keep the merchandise at a reduced price. The price adjustment is then refunded or credited to the customer. Such price adjustments will be deductible if the customer is actually given a refund in cash or a credit in an amount equal to the agreed upon adjustment, plus sales tax on that amount.

AUDIT MANUAL

AUDITS OF SALES IN INTERSTATE OR FOREIGN COMMERCE 0414.00**GENERAL 0414.05**

Regulation 1620 describes the transactions which are exempt from sales tax when shipment is made in interstate or foreign commerce. It also sets forth the conditions which determine whether merchandise shipped into this state is subject to sales tax or use tax.

AUDITING PROCEDURE — SHIPMENTS OUT-OF-STATE 0414.10

The general auditing procedure for sales for resale applies to this deduction. The audit may be made on either a complete basis or a test basis depending on the number and dollar value of the transactions. Examples of documentary evidence to support a deduction as a sale in interstate or foreign commerce are:

- (a) Delivery by facilities operated by the retailer
- Correspondence
 - Delivery receipts
 - Expense vouchers supporting delivery expense

(b) Shipment by carrier

- Freight
 - Bills of lading
 - Freight invoices
- Express
 - Express receipts
 - Express company invoices
- Parcel post
 - Parcel post receipts
 - Record of parcel post shipments

In many instances the sales invoice will show parcel post charges and shipping instructions

- (c) Delivery by the retailer to a customs broker, forwarding agent, export packer or any other person engaged in business of preparing property for export, who is not the purchaser, who ships or delivers the property to a foreign destination as provided in 1620(a)(3)(C)2.(b).

- Bills of lading

The bill of lading shall include the identification of the invoice, contract number or other identification of the transaction involved and the identification of the export packer to which delivery is was made.

- Copies of import documents of foreign country
- Notation on invoice
- Invoices for services of customs broker or forwarding agent
- Delivery receipts

- (d) Delivery to a steamship or other conveyance furnished by a foreign purchaser for shipment to a foreign destination.
- Bills of lading
 - Import documents of a foreign country or other documentary evidence of export must be obtained and retained by retailers to support deductions taken.

In addition to the above, it often is possible to support the exempt status of the shipment by examining purchase orders or other contractual documentation received from the purchaser specifying that the destination of the goods is a specific point outside the United States. The purchase order or contractual documentation received from the purchaser shall include the following minimum elements: 1) a provision requiring or statement indicating that the property is to be delivered by a retailer to an export packer for subsequent shipment to a foreign country; and 2) the specific point outside the United States where the property is shipped. There should be some specificity as to the destination point. The minimum specificity for this element is identification of to whom it is being shipped and in what city and country.

The auditor should note that the following transactions are *taxable*:

- If delivery is made in California to the purchaser or the purchaser's agent, except as permitted in (c) and (d) above.
- If the sale is made to the purchasing carrier which transports the property to an out of state point in the capacity of a purchaser rather than as a common carrier, i.e., the property is not shipped under a commercial bill of lading.

CERTIFICATE OF VERIFICATION — OUT-OF-STATE DELIVERY

0414.12

Generally, a claimed sale in interstate commerce should not be questioned if sufficient evidence of out-of-state shipment is provided as explained in section 0414.10. However, in certain audit situations, additional verification of claimed interstate commerce shipments may disclose that merchandise was not actually shipped to the purchaser, or that the out-of-state shipment consisted of an empty box with the actual merchandise delivered to the purchaser in California. The auditor should be alert to the following situations to determine if additional verification of interstate shipments is warranted:

- The shipping charges for certain interstate shipments are substantially lower than shipments of the same or similar items using the same mode of transportation, for example UPS Ground or Federal Express. (When comparing invoices and shipping charges, the auditor should make sure all the items were included in the shipment and not backordered.)
- The value of the item(s) listed for insurance purposes is substantially lower than the cost of the item(s) to be shipped or there is no insurance at all.
- A large number of high value items are shipped to post office boxes.

Use of Form BOE-52 by Seller

In situations where it appears the taxpayer has met its responsibility in accounting for interstate commerce transactions, but lacks adequate documentation to support certain questioned items, the use of Form BOE-52 (Exhibit 14) and cover letter BOE-52-L (Exhibit 14A) should be discussed as an option. It should be explained to the taxpayer that this certificate may be used to request the purchaser's statement to help substantiate the claimed interstate commerce deduction. It should be emphasized that the return of the certificate may or may not be accepted as support for the claimed exemption.

A period of four weeks will normally be sufficient for the taxpayer to prepare and send the certificate and for a reply to be received. The taxpayer should prepare the certificate to be completed in triplicate. It is recommended that the certificate be returned directly to the Board. If this is the case, the auditor should provide the taxpayer with return envelopes with the address of his or her district or branch office. Please note, business reply envelopes (no postage necessary) should not be used.

The taxpayer may customize the cover letter, Form BOE-52-L, by using the text contained therein on their own letterhead; however, the text in the sample letter should be used without additions, deletions or changes. Any modifications to the cover letter must be approved by the auditor's supervisor.

The taxpayer's customer is asked to return the completed certificate within 10 days. The 10-day requirement is intended to encourage a prompt response from the customer. If the taxpayer chooses the recommended procedure of having the completed certificate returned directly to the Board, the taxpayer may add a request to the cover letter asking its customer to also send a copy of the completed certificate to the taxpayer. The taxpayer's customer should send the originally signed and completed certificate to the Board (may be sent by facsimile). However, if the taxpayer's customer sends the certificate directly to the taxpayer and then the taxpayer sends the certificate to the Board, the Board will accept only the originally signed and completed certificate and will not accept a facsimile copy. If a second certificate is necessary for verification, the auditor should establish a reasonable period of time for completion based on the circumstances involved.

Use of Form BOE-52 by Audit Staff

When the auditor has good reason to believe that merchandise was not shipped as specified by the shipping documents, or that empty boxes may have been shipped to purchasers as a means to support the interstate commerce exemption, it may be appropriate to use Form BOE-52 as a verification method for receipt of out-of-state shipments. In addition to the certificate, Form BOE-52-L1 (Exhibit 14B) provides a suggested cover letter for use by the districts in explaining the purpose of the certificate and requesting the purchaser's statement regarding receipt of the item and place of delivery. The decision to use this verification method should be based on the materiality of the questioned transaction(s) and on the surrounding circumstances. The auditor should prepare the certificate to be completed in triplicate. Postage-paid return envelopes may be included in the mailing to increase the likelihood of response for this case in which the Board is seeking verification of shipment without seller involvement.

Returned Form BOE-52s

As explained above, the seller, or the auditor when the seller is not involved, should prepare the certificate to be completed in triplicate. The original certificate should be included in the audit working papers. If out-of-state delivery is indicated to Arizona, New Mexico, Oklahoma, Texas, Utah, or country of Mexico, a copy should be sent to the attention of the Revenue Opportunity Specialist in the Audit Support Unit (MIC: 44). For all other areas, a copy should be sent to the taxing authority in the state of the purchaser, for example the Department of Revenue of that state. The final copy should be given to the seller for their records.

AUDIT PROCEDURE — SHIPMENTS INTO THE STATE**0414.15**

Property purchased out of state for consumption in California is ordinarily subject to the use tax. In some cases, it is important that the auditor determine whether sales or use tax is applicable to property shipped from a point outside this State to a point inside the State. Examples of documents used to make this determination are:

- Purchase orders
- Sales contracts
- Sales invoices
- Bills of lading
- Freight bills
- Correspondence

In examining the above documents to determine the applicable tax, the auditor should bear in mind that if title to the property (or possession under a conditional sales contract) passes to the purchaser outside this State, the use tax is applicable.

Property purchased by insurance companies for their own consumption is exempt from use tax.

AUDIT OF DEDUCTION FOR LABOR**0415.00****GENERAL****0415.05**

Labor charges to customers may be classified in two categories:

- (a) Exempt
 - Installation
 - Repair or reconditioning
- (b) Taxable
 - Fabrication
 - Assembly

The principal problem involved in auditing the deduction is that of segregating installation and repair labor from fabrication labor and the fair retail price of the merchandise used in repairing or reconditioning property. This problem has been overcome to some extent by authorizing certain classes of businesses, who make lump-sum charges for repairing, to claim as a labor deduction a fixed percentage of the total charges to the customer. Examples of this type of repair are motor rewinding, restringing tennis rackets, etc. In auditing this type of deduction, the auditor should verify total repair sales and apply the authorized percentage.

AUDITING PROCEDURE**0415.10**

Unusual labor charges claimed as deductions should, of course, be examined in detail. However, the deduction for labor usually consists of a great many items so that the audit generally will be made on a test basis such as described under Audit of Sales for Resale, section 0409.00. Sales invoices, together with repair orders, cost sheet and other original documents should be secured for the test period. The total labor claimed during the period tested should be reconciled with the amounts shown by detailed invoices. Differences should be scheduled and a percentage of error computed.

The general rule is that installation and repair labor charges are exempt if segregated in the taxpayer's records. Generally, the segregation is shown on sales invoices, but the deduction should be allowed even though it is not shown on the invoice if either:

- Sales tax has been charged on a portion of the total sales from which the selling price of the material can be computed, or
- The charge for labor is segregated in the sales journal, cost sheets, estimate sheets or repair orders

The segregation should be questioned if material is billed at cost or less with all profit on the transaction allocated to labor. If the retailer does not make a segregation, the retail selling price of the parts and materials will be determined based on information available. In general, the material should be priced at the fair retail value, but if the retail price is not known, the mark-up realized on an entire job should be prorated according to material and labor costs.

Among the problems which may arise in verification of labor deductions are:

- (a) Some repair jobs actually involve both repair and fabrication labor. For example a repairman may, of necessity, fabricate certain parts used in the repair.
- (b) Some remodeling jobs may be either repair or fabrication labor depending upon the end product. For example, labor charges for rebinding a rug are classified as repair. However, labor charges for cutting a rug into two or more pieces and rebinding the pieces so that the customer receives two or more rugs is classified as fabrication labor.
- (c) Audit of labor deductions claimed by construction contractors frequently involves complex problems. Many of these require differentiation between fabrication and installation labor. Others necessitate determining whether the contractor is the consumer or the retailer of the property furnished.
 - A contractor may fabricate and install a fixture. The fabrication labor must be segregated from the installation labor to properly determine the tax liability.
 - A construction contractor, when billing a time-and-material contract, may add tax reimbursement on a marked up price of materials. The amount billed and not the cost should be considered the selling price of the materials.

As many labor operations are borderline, the auditor should make a clear, concise statement of the reason for disallowing each item or category of items; i.e., a machine shop may make a labor charge described as "repairing customer's pipe". An examination of the job record indicates the pipe was "cut into designated lengths and threaded." This brief description indicates fabrication labor, not repair labor, as claimed.

AUDIT OF SALES TAX INCLUDED IN SALES**0416.00****GENERAL****0416.05**

Some retailers, when accounting for total sales, record only the sales price of the merchandise in the sales account and credit sales tax reimbursement to a reserve account. This procedure contemplates a separation of the sales price from the sales tax on either sales tickets or cash register readings. In any event, sales tax collected is not included in reported gross sales.

Other retail establishments such as markets, taverns, and restaurants often find that separation of the sales price from tax reimbursement is not practical, and the entire amount charged the customer is credited to sales. In the latter cases, the taxpayer is entitled to a deduction for sales tax included in total sales provided it can be proved to the satisfaction of the board that they have not absorbed the tax but have actually taken it into consideration in determining the total sales price of the merchandise.

AUDITING PROCEDURE**0416.10**

In cases where a sales tax accrual account is maintained, the clerical accuracy and propriety of the amounts posted to that account should be verified. A sales tax accrual account showing credits only slightly in excess of taxes paid, or payments in excess of collections, does not necessarily indicate errors in reporting.

In reconciling the accrual account, the auditor should adjust for tax on the measure of cash discounts, bad debts claimed, refunds of tax to customers who were charged in error and for any other instances where the taxpayer did not debit the accrual account where such a charge was in order. In addition, the auditor should adjust for such items as reported self-consumed merchandise and any other sales reported on which the taxpayer did not accrue tax. If any excess debit or credit of tax still exists, after making the above adjustments, it should be the taxpayer's responsibility to explain such excesses.

In cases where a deduction is claimed for sales tax included in reported gross sales, the auditor should determine:

- (a) That total amounts of sales tickets are entered in the sales journal.
- (b) If sales tickets are not prepared, that sales tax is rung up on the cash register if it is added to selling prices.
- (c) That where sales tax is not added to sales prices, effect was given to the tax by the retailer in determining the total sales prices.

Regulation 1700 establishes the presumption that the selling price includes tax reimbursement if the taxpayer posts or provides the notices contained in Regulation 1700(a)(2)(C) 1 and 2. Failure by the taxpayer to satisfy these presumptions does not preclude acceptance of other evidence to support the tax included deduction. Claimed "tax included" deductions should be allowed unless there is sufficient evidence to rebut the taxpayer's claim. The mere failure to comply with the presumptions of Regulation 1700 is in itself insufficient proof that the retailer has not included the tax in the selling price.

This deduction is computed after the balance of the audit is completed and is based on audited sales (purchases subject to use tax not included) minus deductions. In order to avoid the allowance of sales tax included on disallowed deductions on which sales tax was not charged, the audited taxable sales (tax included) should be decreased by the amounts of such disallowed sales. Sales tax included in taxable sales may then be computed by multiplying taxable sales (tax included) by a factor.

The factor to be used can be computed as follows:

$$\text{Factor} = \frac{\text{Tax Rate}}{1 + \text{Tax Rate}} = \frac{.0725}{1.00 + .0725} = .067599$$

Factors for other current tax rates are:

Tax Rate	Factor
6.50%	.061033
7.00%	.065421
7.125%	.066511
7.25%	.067599
7.375%	.068685
7.50%	.069767
7.625%	.070848
7.75%	.071926
7.85%	.072786
7.875%	.073001
7.925%	.073431
8.00%	.074074
8.25%	.076212
8.50%	.078341
8.75%	.080460

Sales tax included should be allowed in all audits where sales have been estimated if the basic factors in the estimate include sales tax. For example, where prices which include sales tax are used to develop a mark-up of purchases, the sales estimated by the mark-up method will have the tax included.

TREATMENT OF EXCESS TAX REIMBURSEMENT**0417.00****GENERAL****0417.05**

Retailers sometimes charge their customers tax on exempt sales or, in the case of taxable sales, tax in excess of the amount due. Retailers who have collected excess tax reimbursement should be encouraged to refund the excess tax to their customers. Regulation 1700 explains the sales tax reimbursement rules.

Tax reimbursement greater than the amount of tax imposed upon a transaction is excess tax reimbursement to the extent that it exceeds the taxpayer's own tax liability on the same transaction. If the taxpayer has no tax liability on the transaction, the entire amount of reimbursement collected in excess of the tax imposed on the transaction is excess tax reimbursement and must be returned to the customer. If the taxpayer fails or refuses to return such excess tax reimbursement to the customer, it must be paid to the State whether it was mistakenly computed, or knowingly computed.

REFUNDS OF EXCESS TAX REIMBURSEMENT**0417.07**

Regulation 1700 provides that refunds of amounts of excess tax reimbursement paid to the Board as sales tax may be refunded to the retailer upon submission of "evidence sufficient to establish that excess amounts have been or will be returned to the customer."

This has been construed to mean that the retailer must actually refund amounts collected as excess tax reimbursement to their customers rather than give a credit unless they can show one of the following:

- The customer agrees to a credit.
- The customer's debt to the retailer is acknowledged by the customer or made certain by a court proceeding.
- The amounts to be credited are small and apply to numerous customers.

The retailer should maintain records as provided in Regulation 1700(b)(3) as evidence that the excess amounts have been or will be returned to the customer.

No refund of excess tax reimbursement is allowable without acknowledgement from customers. The BOE-52-L2, Notice of Pending Refund of Excess Sales Tax Reimbursement, (Exhibit 14C) is available to assist the retailer in obtaining sufficient evidence from customers to establish the excess tax amount reimbursements have been or will be returned. The retailer can simply complete the BOE-52-L2 letter for each customer affected and retain the customers' signed responses. The notice informs the customer of the amount of indebtedness in writing and provides a check box for the customer to indicate their preference of a refund or credit to their account for the amount of excess sales tax paid. The retailer must obtain and maintain the signed acknowledgement in their records as proof of the refund or credit being given.

Taxpayers are not required to use this form, however any other type of acknowledgement must satisfy all of the requirements under Regulation 1700 (b)(3)(B). It is not necessary to include copies of the signed acknowledgements in the audit working papers, however verification comments should include complete comments or statements regarding the examination of the acknowledgements and their retention by the taxpayer. Form BOE-52-L2 is available on eBOE.

AUDITING PROCEDURE**0417.10**

The auditor must audit not only on the basis of gross receipts, but must inquire into tax reimbursement on an individual transaction basis. An examination of the sales tax accrual account may indicate an over-collection of tax; however, the overage is seldom the amount of excess reimbursement. In some cases, an overage will result from the breakage factor in following the prescribed reimbursement charts, which is not excess reimbursement. Tests of individual transactions by examining sales invoices, dinner tags, register tapes, contracts, etc., are necessary. When testing discloses a pattern of excess reimbursement to the extent necessary to support an informed opinion (section 0404.15) the auditor should so inform the taxpayer. If the taxpayer does not elect to refund the excess tax to their customers, or cannot, then the auditor should project, or expand the test to estimate the excess tax for the audit period. The measure of excess tax reimbursement disclosed by audit should be separately set forth in the audit report captioned "Measure of Excess Tax Reimbursement."

OFFSETS**0417.15**

Offsets allow a taxpayer to satisfy their tax liability on a transaction by paying to the State an equivalent amount of tax reimbursement collected from a customer on the same transaction. Such offsets can be made only on a transaction-by-transaction basis. Tax reimbursement collected on a specific transaction can be used only to satisfy a tax liability arising from the same transaction. The "same transaction" means all activities involved in the acquisition and disposition of the same property. The "same transaction" may involve several persons, such as a vendor, a subcontractor, a prime contractor, and the final customer; or a vendor, a lessor, and a series of sublessors.

If tax reimbursement equal to or in excess of the tax liability on a transaction is collected and paid to the State, the taxpayer has no further tax liability. Any refund will be limited to the amount paid to the State in excess of the tax liability. If an audit discloses that tax reimbursement was collected in excess of the tax liability on the transaction, and that no tax has been paid to the State on the transaction, the tax liability will be assessed and the tax reimbursement in excess of that amount must be returned to the customer or paid to the State.

A taxpayer may offset tax reimbursement collected on a transaction against their tax liability on the transaction whether the liability was satisfied by paying sales tax reimbursement to a vendor, paying use tax to a vendor, or paying use tax to the State. Tax reimbursement collected from a customer on a transaction is excessive only to the extent that it exceeds the taxpayer's own tax liability on the same transaction.

An offset of a taxpayer's own tax liability against tax reimbursement collected from a customer can be made only with respect to ***transactions in which possession of the property upon which the taxpayer's liability is based is transferred, either permanently or temporarily, to the customer***, as in the case of construction contracts or leases. A taxpayer, such as a repairman, who uses shop supplies in performing a job for a customer cannot offset their tax liability arising from the use of the supplies against tax reimbursement collected from the customer.

SPECIFIC APPLICATIONS**0417.20**

The following examples illustrate the application of tax to certain transactions engaged in by taxpayers.

Lessors of Mobile Transportation Equipment. A lessor of mobile transportation equipment purchases such equipment extax under a resale certificate and collects tax reimbursement on the rental receipts, but pays no tax to the State. The lessor must pay tax on the purchase price of the equipment since a timely election to measure the tax by fair rental value was not made. However, the tax reimbursement collected on rental receipts is excess tax reimbursement only to the extent that it exceeds the tax liability measured by the purchase price. Such excess tax reimbursement must be returned to the lessee or paid to the State.

Other Lessors of Tangible Personal Property. A lessor purchases property and pays sales tax reimbursement on the purchase to the vendor. The property is leased in the same form as acquired and tax reimbursement is collected on the rental receipts. To the extent that the tax reimbursement collected on rental receipts exceeds the tax reimbursement paid on the purchase price, it must be returned to the customer or paid to the State. The law applies in this manner whether the property is leased to a single lessee or a series of lessees.

Construction Contractors. Please refer to section 1207.05 regarding Construction Contractors and possible offsets.

AUDIT MANUAL

AUDIT OF PRESCRIPTION MEDICINES**0418.00****GENERAL****0418.05**

Medicines sold under a prescription issued by a physician, dentist, surgeon, or podiatrist for the treatment of a human being, and filled by a registered pharmacist, are exempt from the sales tax. In addition, effective January 1, 1995, tax does not apply to medicine furnished by a pharmaceutical manufacturer or distributor without charge to a licensed physician, surgeon, dentist, podiatrist, or health facility for the treatment of a human being, or to an institution of higher education for instruction or research. For definitions of terminology, and other conditions under which medicines are exempt, see the applicable sections of the law, rules and regulations. From an audit standpoint, exempt sales to and by doctors, dentists, hospitals and certain political entities present no particular problem. The following section is limited to auditing prescription pharmacies.

AUDITING PROCEDURE**0418.10**

Section 4331 of the Business and Professions Code requires that all prescriptions filled shall be kept on file and open for inspection by duly constituted authorities. Also, Regulation 1591 requires that “any deduction on account of sales of medicines shall be supported by appropriate records.” The only records specifically required by regulation are the prescriptions themselves, which must be numbered and filed in numerical sequence. Refills are required to be noted on the reverse side of the prescription, or on a separate attachment thereto, with the date of refilling and initialed by the pharmacist.

Many pharmacies keep a “prescription register” to record the prescription number, prescriber’s name, patient’s name, date sold, and the sales price of the prescription. When pharmacies use this “register” as a basis for their deduction the auditor need only apply normal verification techniques to determine the accuracy of the claimed deduction. Where such a “register” is not kept, the auditor should first determine taxpayer’s method of compiling the deduction and apply appropriate testing techniques to verify the accuracy of the detail supporting the compilation of the deduction. The auditor should be mindful of the requirement in Regulation 1591 that the taxpayer must support the claimed deduction by appropriate records.

AUDIT MANUAL

AUDIT OF OTHER DEDUCTIONS**0419.00****AUDIT OF BAD DEBT DEDUCTIONS — GENERAL****0419.03**

A deduction may be claimed for the measure of tax represented by accounts on which the retailer paid the sales or use tax and which were found to be worthless and charged off for income tax purposes, or if the retailer is not required to file income tax returns, charged off in accordance with generally accepted principles. The fact that the account was written off is sufficient to allow the deduction if all other prescribed conditions are met. The auditor need not be concerned with whether the account is actually worthless. Bad debts may originate from sales on open accounts, unsecured installment sales, or from repossessions of merchandise sold on a conditional sales contract.

Amounts charged off usually will be greater than amounts allowable as a deduction under the Sales and Use Tax Law. This is because amounts charged off may include charges for sales tax reimbursement, labor, transportation, etc., or the whole amount may represent a sale for resale or a sale in interstate or foreign commerce. The auditor must therefore analyze the sales which are the basis for claimed bad debt deductions, either on an actual or test basis.

Generally a retailer has a bad debt deduction if the selling price upon which tax was reported and paid is more than the payments, trade-in allowances, and other credits applicable to the sale. The wholesale value of merchandise repossessed is an example of "other credits."

The allowable loss for sales and use tax purposes is the pro-rata portion of the book loss which the taxable sales price of the tangible bears to the total sales price which may include exempt tangible items composing the sale.

An example of a computation of the allowable loss follows:

Original Sales Price Tangible Personal Property		\$200
Installation Labor and Insurance		10
Sales Tax		14
Gross Sales Price		<u>\$224</u>
Total Consideration Received:		
Cash Down	\$50	
Cash paid on Account	<u>25</u>	<u>75</u>
Book Loss per Records		<u>\$149</u>
Loss Allowable for Sales Tax Purposes:		

$$\frac{\$ 200}{\$ 222} \times \$ 149 = 132$$

Many retailers fail to claim a bad debt deduction. If at the time of audit the taxpayer has not worked up the data to support an allowable deduction, they should be furnished the format as outlined in Regulation 1642 and asked to compile the information.

Verification of bad debts may be made on a test basis. Representative periods should be selected with concurrence of the taxpayer. The percentage of overstatement or understatement computed during the test periods will be applied to all other periods of the audit. Audited differences will be used for the test periods.

Certain larger retailers such as department stores are authorized to compute deductions on a formula basis. Formulas approved by the Board take into account the retailer's bad debt experience, both as to losses and recoveries, over substantial periods of time. Such a formula appears in section 0419.15.

AUDITING PROCEDURE

0419.10

The auditor should review the accounting records and income tax returns to determine that bad debts have been properly written off. Auditors should satisfy themselves that the method used by the taxpayer to arrive at the allowable deduction is substantially correct. Special attention should be directed to the following:

- *Was Sale Prior to a Change in the Tax Rate?*

An adjustment must be made to compensate for the tax rate differential between sales made at one rate and claimed as bad debts after the rate has changed or a district tax has been added or discontinued. The audit report should be completed in such a manner that tax credit will be given for state, local, county and district tax.

- *Effect of Charging an Account Other Than Bad Debt Expense for the Repossession Loss*

Many accounting systems require charging repossession losses directly against the cost of goods sold or other cost account rather than Bad Debt Expense. This method has the same general effect on the financial condition and therefore is an acceptable write-off method.

- *Effect of Reporting on a Cash Basis*

If retailers have been reporting their sales tax liability on a cash basis, ordinarily no bad debt deduction will be allowed. This is because sales tax has not previously been paid on the accounts deemed to be worthless. If accounts receivable have been picked up in a previous audit, a bad debt deduction may be allowed for any such receivables which subsequently go bad even though the taxpayer continued to report on a cash basis.

As provided in Regulation 1642, Bad Debts, a bad debt deduction will not be disallowed solely for the reason that a retailer is on a cash reporting basis for income tax purposes.

- *Consolidation of Debts*

The auditor should determine that the remaining contract balance (net payoff) is a measure of the taxable sale only. Some retailers consolidate other debts of the customer into the contract which do not pertain to the allowable loss.

- *Worthless Accounts Subsequently Collected*

General accounting records should be reviewed to determine that collections of previously written off accounts have been properly reported for sales tax purposes. These should be reported on the same pro-rate basis used for claiming the bad debt deductions, i.e., ratably allocated to the taxable and nontaxable elements of the original sale. If, however, delinquency charges have accrued, collections may be applied to such charges first and remainder then pro-rated to determine the taxable portion to be reported.

- *Collection Expense*

Collection agencies charge a fee for their services, normally 50% of the amount collected by them. Any amount paid directly to or retained by a collection agency in attempting to enforce collection of amounts owing is not allowable as part of the bad debt loss.

Review should be made of receipts from the collection agency to assure that amounts shown as collected are gross, including the collection charge.

- *Insurance Indemnification*

Review of accounting records should include a search for insurance recoveries on accounts receivables, property damage, and similar type insurance policies applicable to sustained bad debt losses. Any such indemnification should be used to reduce the allowable bad debt loss.

The verification of repossession losses should include, as standard procedure, sufficient testing to insure that all repossessed merchandise is brought back into inventory or has been resold. A comparison of the value used for computing the bad debt loss with the subsequent selling price should show a reasonable relationship.

SPECIAL SITUATIONS**0419.15****Bad Debts Incurred by Lessors**

- A bad debt deduction is allowable on reported taxable rental receipts which are found to be worthless and charged off for income tax purposes.
- On leases or renewals of leases, the lessor is required to collect use tax from the lessee at the time rentals are paid by the lessee and to pay the tax during the corresponding reporting period. If the lessor has computed and paid tax to the state on lease payments that were due but not paid by the lessee, then the lessor has made a tax overpayment subject to refund or credit. Therefore, the taxpayer may claim a refund without having to write off the account as a bad debt for income tax purposes. If however, the account was properly written off and claimed as a bad debt deduction, it should be allowed.
- When leases of tangible personal property situated in this State are not subject to use tax because of the exempt status of the lessee (e.g. insurance companies), the lessor nevertheless is subject to sales tax measured by the rental receipts. Therefore, taxes are due from the lessor on the basis of rentals payable and not rentals paid, and a valid bad debt deduction may result for sales tax purposes.

Bad Debt Deductions to Persons Other Than the Retailer

- A successor who pays full consideration for receivables acquired from their predecessor is entitled to a bad debt deduction to the same extent that the predecessor would have been had they continued the business.
- A retailer who sells receivables at a discount cannot obtain a bad debt deduction for the amount of the discount.
- See section 0419.17 for audit procedures on bad debt deductions claimed by lenders on purchased receivables.

Bad Debts of Construction Contractors

- When under a time and material contract a contractor bills their customer for tax reimbursement computed upon a marked-up price for materials, pays the tax accordingly and the receivable is thereafter found to be worthless and charged off for income tax purposes, or if the contractor is not required to file income tax returns, charged off in accordance with generally accepted accounting principles, a bad debt deduction may be taken by the contractor for the total amount. The contractor is a retailer in this situation.
- Since a contractor is the retailer of fixtures (other than those used in performance of contracts with the United States) bad debt losses incurred in connection with the furnishing and installing of fixtures are to be treated in the same manner as those resulting from other types of retail sales.

Bad Debts for Department Stores Using Formula under Regulation 1642 in Determining Sales Tax Credit for Bad Debts – CONTRACT METHOD

- The provisions of Regulation 1641, Credit Sales and Repossessions, and Regulation 1642, Bad Debts, apply when considering bad debts as an allowable deduction.
- Certain retailers, such as department stores, are authorized to compute deductions on a contract basis. This formula has been authorized for the computation of allowable bad debt deductions. The formula follows:
 1. Determine the relationship between taxable sales per the tax returns and gross charges per the books for the last available calendar year. In almost every retail store this calculation can be made from the normal quarterly reconciliations of book totals representing total net register sales with taxable sales per the return. Only sales from California outlets should be included in the formula.

EXAMPLE:

Gross registered sales per sales audit including retail sales tax.....	\$0.00
Less gross returns and credits per sales audit.....	<u>0.00</u>
(A) Net Register Sales.....	\$0.00
Add unallowable credits:	
Trade-ins	\$0.00
Market value of repossession	0.00
Expense allowances included in credits.....	0.00
Partial credit returns.....	0.00
Miscellaneous unallowable credits.....	<u>0.00</u> \$0.00
SUB TOTAL	\$0.00
Less exempt transactions included in (A) above:	
Sales for resale	\$0.00
Sales of food products	0.00
Sales to U.S. Government.....	0.00
Out-of-state sales	\$0.00
Less shipping charges included.....	(0.00)
Fed. Excise Tax included.....	<u>(0.00)</u> \$0.00
Federal Excise Tax.....	0.00
Retail Sales Tax	0.00
Other exemptions:	
Sales of merchandise certificates on register	0.00
Hunting and fishing licenses run on register	0.00
Exempt shipping charges.....	0.00
Non-taxable sales in cost and leased workroom departments.....	0.00
Non-taxable sales of concessions included in sales per our return.....	0.00
Sales of concessions who report their own sales tax.....	0.00
Miscellaneous exemptions	\$0.00
(B) Taxable Merchandise Sales per return before taking bad debt deduction	<u>\$0.00</u>
Annual percentage of taxable sales per return to net register =	
(B) Merchandise Sales per Return	<u> </u>
(A) Net Register Sales	<u> </u>

2. Determine the relationship of the carrying charge balance to the charge sale balance under the financing contract at the time of write off. A test will be performed to determine the relationship between carrying charges and sales balance. A representative sample of transactions should be chosen and must be of a size or number of periods that will result in an accurate factor. This test should be repeated at least every three year and updated whenever there is material change in the age of bad debts, the method of contracting charge sales, or other changes which may affect the factor.

	CARRYING CHARGES AT WRITE OFF	TOTAL WRITE OFF	CARRYING CHARGES AS % OF TOTAL WRITE OFFS
30 Day	\$0.00	\$0.00	0.0%
Revolving	0.00	0.00	0.0
Service	0.00	0.00	0.0
Lease	0.00	0.00	0.0
Total	\$0.00	\$0.00	0.0

3. Determine the ratio of recoveries to charge off for the two preceding fiscal years:

	CARRYING CHARGES AT WRITE OFF	TOTAL WRITE OFF	CARRYING CHARGES AS % OF TOTAL WRITE OFFS
30 Day	\$0.00	\$0.00	0.0%
Revolving	0.00	0.00	0.0
Service	0.00	0.00	0.0
Lease	0.00	0.00	0.0
Total	\$0.00	\$0.00	0.0

$$\text{Average Net Loss Percent} = \frac{\text{Total Column III}}{\text{Total Column I}}$$

Result: Having made the calculations involved in (1) to (3), proceed to make the calculations for the Quarterly return as follows:

- (a) Apply the percentage obtained in (3) to the total accounts being written off. Thus, anticipated future recoveries are taken into consideration at time of charge off and only expected eventual net loss is used as the basis for deduction on the sales tax return.
- (b) Reduce the amount obtained in (a) by the amount of carrying charge included as determined by average percentage obtained in (2). Thus, carrying charge element included in net charge off is eliminated.
- (c) Reduce the result obtained in (b) by the percentage determined in (1). Thus, the gross write-offs for the quarter have been adjusted for nontaxable elements and now reflect the allowable bad debt deduction on taxable sales.

- It is important to note that the effect of these calculations and application of the formulas results in a completely equitable deduction for bad debts for purposes of the return even though a customer's account being written off contains charges arising from sales made by concessions reporting their own sales and some non-taxable sales by concessions included in company return, some exempt workroom sales, carrying charges, etc. If each charge off and recovery had to be analyzed and scheduled, the retailer could not afford to make the calculations involved, nor could the State afford to audit them. Under this method, the State always has the use of the money representing the tax effect of anticipated future recoveries, which in view of saving in clerical cost is well worth the sacrifice to the retailer.

BAD DEBTS INCURRED BY LENDERS ON PURCHASED ACCOUNTS RECEIVABLE

0419.17

General

A retailer may sell an account receivable ("account") 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.

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 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) superseded and replaced the WFS memorandum opinion. 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 3rd 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 must include in the general comment section of the audit 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 losses so 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 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 the auditor verifies the accuracy of the lender's listing using statistical sampling techniques. The auditor must follow the guidelines for performing a statistical sample set forth in AM Chapter 13, Statistical Sampling, except for the sample size noted below.

When statistical sampling is used the auditor must select a sample size of at least 10 percent of the population. 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, 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. The auditor must perform a statistical sample of the transactions to compute the allowable portion of the bad debt loss, in accordance with the guidelines set forth in AM Chapter 13, Statistical Sampling. However, the auditor must select a sample size of at least 10 percent of the population. 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). 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 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 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, 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 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 10 percent of loan contracts (population) selected using statistical sampling procedures (i.e., random, systematic with random start, etc.).
- 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 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.

CREDIT FOR TAX PAID TO OTHER STATES, SECTION 6406 CREDIT**0419.20**

Credit for sales or use tax imposed by other states and paid on purchases of tangible personal property may be taken as a credit against the amount of tax due. The property must have been purchased for use, consumption or storage (not resale) in California. The department's administrative practice is not to question the validity of the imposition of a tax by another state. If the purchaser can show that tax was paid to another state on a transaction subject to use tax in California, the credit is allowable.

The only two exceptions to this general practice are: (1) when the taxpayer obtains a refund of the tax paid to the other state prior to our review of the transaction, or (2) when it can be shown that the purchaser or vendor is intentionally reporting tax to the other state in order to take advantage of the section 6406 credit.

With respect to vehicles, vessels and aircraft, the section 6406 credit shall be denied when tax on the sale or purchase of the vehicle, vessel or aircraft was first due in California.

Auditing procedure normally includes verifying the purchase invoices to ascertain that the purchase price was included on Line 2 of the return and to verify the amount of section 6406 credit claimed on the return. The auditor must also verify that the tax (amount of credit claimed) was paid either to the retailer located in another state or to that state itself. Section 6406 also provides that credit is not allowed on out of state tax measured by periodic payments made under a lease for a period prior to the storage, use or other consumption of the property in this State.

The amount of tax credit claimed may not exceed the lesser of (1) the tax actually paid and owed to another state, or (2) the tax computed using the combined state and local tax rates in effect at the time the property was first brought to California. Section 0203.16 describes the method of handling the difference developed in this portion of the audit.

The section 6406 credit is apportioned to the county tax and transit tax against which it is allowed in proportion to the amounts of those taxes.

TAX PAID PURCHASES RESOLD**0419.25**

Regulation 1701 provides that a retailer who resells tangible personal property before making any use thereof (other than retention, demonstration or display while holding it for sale in the regular course of business) may take a deduction of the purchase price of the property if, with respect to its purchase, the retailer has reimbursed their vendor for the sales tax or has paid the use tax. The sole criteria is that the retailer must have some taxable measure whether sales tax or self-accrued use tax, or otherwise, against which a deduction may be taken.

The allowable deduction is the original purchase price of the property upon which tax has been paid regardless of the subsequent sales price. If this type of property is sold at a loss, the deduction is still allowable on the basis of the original purchase price. The following examples illustrate the allowable deduction:

Original purchase price	\$500.00	500.00
Tax paid 7.25%	36.25	36.25
<hr/>		
Subsequent sales price	500.00	700.00
Sales tax 7.25%	36.25	50.75
<hr/>		
Allowable deduction	500.00	500.00

Exceptions to this policy are:

- Property acquired on a tax-paid basis and leased in substantially the same form as acquired cannot be converted into a sale by taking a tax paid purchases resold credit.
- Property acquired on a tax-paid basis and placed in standby service will be considered used. This will preclude a tax-paid purchase resold deduction if the property is located at the place of intended use and committed to that use, even though never physically used there and it is ultimately removed and sold.

If credit is allowed for tax paid purchases resold and there is some question that the supplier might also refund the tax, the facts should be stated in a memorandum and forwarded to the district office in which the vendor is located.

AUDIT OF CHARITABLE ORGANIZATIONS

0419.30

Sales made by charitable organizations are exempt provided the conditions included in Regulation 1570 are met. Compliance Policy and Procedures Manual section 255.050 also contains information relating to charitable organizations.

Included among the conditions that must be met is that each year a “welfare exemption” from property taxation must be secured. The exemption claim is filed through the County Assessor’s Office by March 15 of each year. Sales are taxable during a year for which an organization does not qualify for a “welfare exemption.” The procedure by which an organization qualifies for an exemption appears in CPPM. The auditor should ascertain that the exemption covers all real and/or personal property owned by the organization and situated at the location from which the sales are made. An organization not owning the real property must qualify for an exemption of the personal property at that location.

Organizations that started after the filing date should make application to the County Assessor to find out whether or not they qualify for the exemption. The organization should receive a letter, which informs them that they qualify, from the Assessor or the Assessment Policy and Standards Division of the Board’s Property and Special Taxes Department. Such a letter exempts them from the payment of sales tax pending their qualifying at the normal filing time.

Sales or use tax applies to sales to charitable organizations of tools, supplies, and equipment when the property is used or consumed by the organization. Effective January 1, 1990 sales or use tax does not apply to purchases by the organization of tangible personal property for the purpose of donation.

NEW OR REMANUFACTURED TRUCKS, TRUCK TRACTORS, TRAILERS, OR SEMITRAILERS

0419.45

Sections 6388 and 6388.5 provide sales and use tax exemptions on the sale, or storage, use or other consumption of certain vehicles and trailers delivered inside California. Regulation 1620.1, *Sales of Certain Vehicles and Trailers for Use in Interstate or Out-of-State Commerce*, clarifies these exemptions and describes the records needed to support the exemptions.

Section 6388 Exemption (Regulation 1620.1(b)(2)):

This exemption typically shows up in audits of vehicle manufacturers or remanufacturers who deliver a vehicle [as defined in subdivision 1620.1(a)(8) “vehicle” includes certain trailers] to a purchaser who is not a resident of California for use exclusively in out-of-state or foreign commerce, when the purchaser:

1. Purchases the vehicle from a dealer located outside California,
2. Removes the vehicle from California within 30 days from the date of delivery,
3. Provides an affidavit to the manufacturer or remanufacturer, stating:
 - a. The name and location of the out-of-state dealer from whom the vehicle was purchased,
 - b. The name and location of the in-state manufacturer or remanufacturer that delivered the vehicle to the purchaser and the date of delivery,
 - c. That the purchaser is not a resident of California,
 - d. That the vehicle was purchased for use exclusively outside California,
 - e. That the vehicle was removed from California within 30 days of the delivery date, and
 - f. The date of removal, and
4. Provides evidence of out-of-state vehicle registration [state of registration, license plate number and Vehicle Identification Number (VIN) or serial number] to the manufacturer or remanufacturer within 60 days of providing the affidavit to the deliverer.

To file the affidavit, the purchaser should use form BOE-837. Alternative documentation is permissible as long as it contains all the information required by form BOE-837.

Audits of vehicle manufacturers and remanufacturers: Manufacturers and remanufacturers should have an affidavit and registration documentation on file to support a claimed exempt transfer of a vehicle. Note: It is rebuttably presumed that a vehicle registered outside California and apportioned for use within California is not purchased for use exclusively outside California.

Audits of purchasers: The Board may audit purchasers claiming exemption under Regulation 1620.1(b)(2). Under this exemption, purchasers must maintain internal records documenting that the qualifying vehicle was taken out of California within the time mandated by statute and was used exclusively outside California. Examples of documentary evidence are bills of lading showing the first functional use of the vehicle, vehicle logs/reports, fuel receipts, hotel bills, and copies of license or registration fee receipts showing the date of payment. Purchasers should also be able to show that they are residents of somewhere other than California.

Section 6388.5 Exemption (1620.1(b)(3)):

This exemption typically shows up in audits of trailer manufacturers or remanufacturers, dealers, or purchasers. To qualify for exemption, the purchaser must use the trailer exclusively in interstate, out-of-state, or foreign commerce and meet the following criteria:

1. A trailer that is manufactured or remanufactured outside California must be removed from California within 30 days from the date of delivery; or a trailer that is manufactured or remanufactured within California must be removed from California within 75 days from the date of delivery.

2. If the trailer is registered outside the state, the purchaser or purchaser's agent provides the delivering manufacturer, remanufacturer, or dealer a copy of the current out-of-state license and registration for the trailer showing the VIN or serial number; or, if the trailer is registered in-state under the PTI (Permanent Trailer Identification) program, the purchaser or purchaser's agent provides the delivering manufacturer, remanufacturer, or dealer a copy of the federal document assigning or confirming the purchaser's or lessee's USDOT (United States Department of Transportation) number, FMC (Federal Maritime Commission) number, or a copy of the current SSRS (Single State Registration System) filing with the DMV. A purchaser or purchaser's agent may not use an FMC number if the purchaser has a current USDOT number. Evidence of registration outside California must be submitted to the dealer, manufacturer, or remanufacturer no later than 60 days after the timely providing of an affidavit described in subdivision 1620.1(b)(3)(A)3. Evidence of a USDOT number, FMC number, or SSRS filing must be submitted with the affidavit. [Descriptions of the PTI, USDOT, FMC, and SSRS programs are described in Regulation 1620.1(a).]
3. The purchaser or purchaser's agent must also provide a valid affidavit to the manufacturer, remanufacturer, or dealer, stating:
 - a. The name and location of the dealer from whom the trailer was purchased,
 - b. The name and location of the California dealer, manufacturer or remanufacturer that delivered the trailer to the purchaser and the date of delivery,
 - c. That the vehicle was purchased for use exclusively outside the state, or exclusively in interstate or foreign commerce, or both,
 - d. That the vehicle was removed from the state within the appropriate time periods provided for in subdivision 1620.1(b)(3)(A)(1), and
 - e. The date of removal.

As noted in the previous section, the purchaser must use form BOE-837 or its equivalent as the affidavit.

Audits of purchasers: Purchasers of trailers under this exemption must maintain internal records documenting that the qualifying trailer was taken out of California within the mandated time and was used exclusively in out-of-state, foreign or interstate commerce. Examples of documentary evidence are bills of lading (also indicating the first functional use of the vehicle), vehicle logs/reports, fuel receipts, hotel bills, and copies of license or registration fee receipts showing the date of payment.

Note: the exemption under 1620.1(b)(3) only applies to trailers and semitrailers – it does not apply to trucks or truck tractors.

SALES TAX EXEMPTION FOR FOREIGN DIPLOMATS**0419.50**

Effective February 15, 1986, the U.S. Department of State began issuing Tax Exemption Cards to foreign diplomatic personnel who are exempt from sales tax. Each card includes the name of the person to whom it is issued, personal identification information, a photograph, an expiration date, and a tax exemption number. Many diplomatic personnel who enjoyed an exemption from sales taxes under the former program (in which cards were issued by the Board) have been denied immunity entirely. The U.S. Department of State cards will specify either that the holder of the card is exempt from sales tax on all sales or that the holder of the card is exempt from sales tax only on transactions which exceed an amount stated on the card. For example, if the tax exemption card is granted for a minimum level of exemption of \$50, as indicated on the card, the purchaser must purchase merchandise aggregating over \$50 in a single transaction to qualify for the exemption. The total purchase may be composed of all taxable merchandise or a combination of taxable and non-taxable merchandise, i.e., a sale of cigarettes for \$6 is exempt if sold together with \$45 non-taxable food products. Separate purchases in the same store will not qualify if the amount of each transaction does not exceed the amount indicated on the card, even though the combination of all individual purchases in that store may exceed that amount.

To support the exemption, the retailer must prepare and retain an invoice or other written evidence of the sale and should enter the name of the purchaser, the number of the exemption card, the name of the foreign mission, the expiration date of the card, and the minimum level of exemption specified on the card, if any.

Questions regarding the validity of tax exemption cards may be directed by telephone to the U.S. State Department, Office of Foreign Missions.

For special rules regarding sales of vehicles, see Chapter 6, "Vehicle, Vessel and Aircraft Dealers."

Taiwan Diplomats Tax Exemption Cards — The United States' Taiwan Relations Act established a nonprofit corporation called the American Institute in Taiwan, which functions much like a foreign embassy. The Act also exempted the Institute from any taxes imposed by any state or local taxing authority. Pursuant to the Act, the United States Department of State issues a tax exemption card to members of the Institute.

Sales or use tax does not apply to the sale or use of personal property sold to Taiwan diplomats holding a tax exemption card, to the level of exemption stated on the card. Questions regarding the status of a tax exemption card of a Taiwan diplomat may be made by telephone to the American Institute in Taiwan at (703) 525-8474. The fax number is (703) 841-1385. The address is 1700 N. Moore St., 17th Floor, Arlington, VA 22209.

AUDIT OF FOOD STAMP DEDUCTION**0419.60**

Products which are *eligible* to be purchased with food stamps and *are* so purchased are not subject to the sales and use tax. Products which are normally taxable, but are exempt when purchased with food stamps include among other things: non-alcoholic carbonated beverages and ice. This deduction will normally be found when auditing grocery stores; however, it could be claimed by mini-marts, liquor stores, drugstores with food sections, and other retailers which are eligible to accept food stamps.

Taxpayers may claim the deduction on an actual basis, as an amount equal to 2% of the food stamps redeemed during the period of the return, or as a percentage computed by the taxpayer in accordance with Regulation 1602.5(c).

As this deduction will usually be rather small, any large claimed deductions will warrant careful examination.

FEDERAL EXCISE TAX**0419.65**

Gross receipts subject to sales tax include the amount of any manufacturer's or importer's excise tax included in the price of the merchandise, whether or not separately stated.

Taxable receipts do not include any federal tax, with respect to a retail sale, imposed upon the retailer or consumer such as a federal tax on the sale of jewelry, luggage, furs, etc. (Regulation 1617, Federal Taxes.) However, retailers must retain records to show that the amounts deducted as federal tax have been returned to the United States or will be returned to the United States in accordance with section 4053 of the Internal Revenue Code.

AUDIT OF LEASES**0420.00****GENERAL****0420.05**

There are three basic ways that the tax applies to leases, and the variability of this treatment depends on the type of property being leased, the means by which a lessor obtained the property, and the contract between the lessor and lessee. Some leases are taxed based on the cost of the property being leased, some are taxed based on the rental receipts, and some leases are taxed based on the fair rental value of the property being leased. Regulations 1660 and 1661 explain the application of tax to leases.

AUDITING PROCEDURE**0420.10**

The auditor should determine the taxpayer's method of reporting tax on leased property. Most taxpayers choose one reporting method (cost, rental receipts or fair rental value) and use that method exclusively for all lease transactions. Under this situation, the audit may be made on either a complete or test basis depending on the number and dollar value of the lease transactions. When a taxpayer reports leases under more than one method, a more detailed analysis of the transactions will be required to assure there are no errors in reporting lease transactions.

Auditors should always keep in mind the various criteria that are applied to leases to determine the application of tax:

- How was the property obtained by the lessor?
- What is the nature of the property being leased?
- Was the election of the lessor made timely?
- Is the transaction a lease or sale?

The auditor should be alert to the following areas that cause misunderstandings in the application of tax to leases:

- The sale was an occasional sale.
- Property affixed to realty.
- Tax paid to another state.

TIMELY ELECTION**0420.15**

It should be stressed that in order for a lessor to utilize the available options to determine the measure of tax, an election must be made timely. Generally, a timely election means that the election must be made on the return for the reporting period in which the leased equipment first enters lease service. Clerical oversight is not an acceptable excuse for not making a timely election. Once the election is made, it is irrevocable.

ITEMS INCLUDED IN RENTAL RECEIPTS**0420.20**

The following items are generally considered to be included in rental receipts (these rules apply when the rental receipts are subject to tax):

- **LICENSE and ROYALTY CHARGES.** If a rental or lease agreement calls for a royalty to be paid based on units produced or for use of the property, such royalties are includable in rental receipts. For example: a computer company sells pre-written software in a taxable transaction. Charges for site license fees that permit purchasers to install additional copies of the program on other computers represent additional gross receipts from the original sale of the program.

- **ADVANCE RENTALS.** Advance rental payments received by the lessor at the time the lease commences are subject to the tax at the time the amounts are paid by the lessee. It is immaterial that the advance rental payment is designated as applicable to the final period of the lease. Generally, if the amount collected at the commencement of a lease is designated as a "security deposit" rather than an advance rental, the amount collected would not be subject to tax until it is actually applied to a rental payment.
- **CHARGES DESIGNATED AS INTEREST.** When equipment is actually leased and not sold on credit, the amounts designated by the lessor as interest which are payable by the lessee, in addition to amounts designated as rentals, are includable in the rental payments subject to tax.
- **PROPERTY TAX.** When a lessee is required by the rental contract to pay for any personal property taxes assessed on the lease property, such amounts are regarded as part of the taxable rental receipts whether the personal property tax is assessed directly against the lessee or the lessor. (Exception: Personal property taxes are not included in rental receipts when assessed against personal property where a bank or financial corporation is the lessor and pays in lieu franchise tax on net income to California. The California Franchise Tax Board maintains a listing of banks and financial corporations that pay in lieu tax.)
- **MANDATORY CHARGES.** When the lessee is obligated under the lease contract to use services provided by the lessor such as equipment maintenance, warranty, assembly, disassembly, etc., such additional charges are includable in rental receipts. However, if the lease contract merely requires that the lessee maintain the property, the lessee's maintenance costs are not includable in rental receipts.

Another example of mandatory charges is the collision damage insurance supplement offered generally by daily car rental companies. If it is required that the customer purchase the insurance as part of the rental agreement, such charges are includable in rental receipts.

- **DEFICIENCY CHARGES.** These charges generally represent the difference between the actual value of the property returned to the lessor by the lessee at the termination of the lease and the value of the property prescribed in the lease contract upon which the periodic rentals were based. Such additional deficiency charges are includable in rental receipts. On the other hand, credits to lessees represent a reduction in rental receipts if these adjustments are called for in the lease contract.
- **DELIVERY CHARGES.** In those circumstances where delivery of tangible personal property is made by facilities of the lessor (as distinguished from an independent contract carrier), the delivery charge is included in the measure of tax unless the transportation occurs after possession of the leased property is transferred to the lessee or after the right to possession is granted to the lessee and the delivery charges are separately stated.
Charges for delivery made by an independent contract carrier may also be taxable where the sale is made for a delivered price.
- **RETURN TRANSPORTATION CHARGES.** Transportation charges at the termination of a lease for return of rented property from the lessee to the lessor are subject to tax unless the lessee has the option to provide his own return transportation. Such charges must also be separately stated and not be included with delivery charges in order to be exempt.

ITEMS EXCLUDED FROM RENTAL RECEIPTS**0420.25**

The following items are generally considered to be excludable from rental receipts subject to tax (these rules apply when the rental receipts are subject to tax):

- **OPTIONAL CHARGES.** These are the opposite of mandatory charges discussed previously. For example, when the lessee is not obligated to use the maintenance or other service provided by the lessor, or to accept the collision damage insurance supplemental offered by the daily car rental company, but chooses voluntarily to do so, the additional charges are not includable in rental receipts subject to tax.
- **LATE CHARGES.** An additional payment made by a lessee for failing to pay the rental payment timely is not regarded as part of the taxable rental receipts.
- **AUTOMOBILE ANNUAL LICENSE FEES.** The annual license fees and taxes on motor vehicles are not includable in rental receipts whether paid by the lessor or lessee. This differs from the treatment of property tax. The annual license fees and taxes on vehicles are specifically exempt by law from the measure of tax.

SALE OF LEASED PROPERTY BY LESSOR**0420.30**

Sale of leased property by the lessor is subject to sales or use tax in the same manner as sales generally. The election chosen by the lessor at the commencement of the lease does not alter the tax application to sales of leased property by lessors. Where the lease agreement provides the lessee with an option to purchase the leased property, a sale occurs and tax is due based on that sale at the time the option is exercised.

REPAIR AND MAINTENANCE CONTRACTS**0420.35**

Sales tax does not apply to sales of repair parts to a lessor which are used by the lessor in maintaining the leased equipment pursuant to a mandatory maintenance contract where the rental receipts are subject to tax. Such repair parts are regarded as being part of the sale of the leased item and may be purchased for resale.

The lessor is the consumer of repair parts used to repair equipment where an optional maintenance agreement exists. If the lessor makes a separate charge to the lessee for the parts, the lessor is a retailer of the parts.

FUEL USED IN RENTAL VEHICLES “WET RENTALS”**0420.40**

A “wet rental” is a lease of a vehicle in which the total rental charge includes fuel furnished by the lessor. Whether the sale of the fuel to the lessor is subject to sales or use tax depends on whether the lessor is the retailer or the consumer of the fuel furnished.

Lessor is Retailer of Fuel. — When the lease of a vehicle is subject to tax as a continuing sale, the lessor is the retailer of fuel furnished under wet rentals of the vehicles. Such fuel may be purchased ex-tax under a resale certificate, and if sales or use tax is reported and paid on the total rental receipts no additional tax liability accrues.

Lessor is Consumer of Fuel. — When the lease of a vehicle is not a continuing sale because tax has been paid on the cost of the vehicle, or because the vehicle is mobile transportation equipment, the lessor is the consumer of fuel furnished under a wet rental, and tax applies to the sale of fuel to the lessor. However, if the lessor makes a separate charge to the lessee for the fuel, the lessor is the retailer of such fuel and the retail sale of the fuel is subject to sales tax. In that case the lessor may purchase the fuel ex-tax under a resale certificate.

AUDIT OF SALE AND LEASEBACK TRANSACTIONS**0420.45**

In analyzing sale and leaseback transactions, the primary consideration is the intent of the parties at the time they entered into the transaction i.e., did the parties intend to sell the equipment and enter into a subsequent lease or did the parties intend to enter into a financing agreement. If the agreement describes the transaction as a sale transaction and as a lease transaction, this is some evidence that the parties intended that the transaction have those legal effects. Consequently, all sales and leaseback transactions should be taxed in accordance with their express terms unless it is clearly established that the transactions are financing agreements.

Taxpayers must establish that all of the following factors are present to establish that a transaction, which is in the form of a sale and leaseback, is, in substance, a financing transaction only.

1. Ownership of property under the contract reverts to the “lessee” upon completion of all lease payments. The presence of an option to purchase in a leaseback agreement does not itself necessarily preclude the transaction from being treated as a loan for sales and use tax purposes. The fact that title might not pass automatically to the “lessee” at the end of the lease term, or upon the payment of a mandatory amount (whether nominal or not), but only upon the payment of an option price, will not in itself result in the transaction being treated as a sale and leaseback, provided the economic circumstances (option price is fair market value or less) are such that it is readily apparent that the option will be exercised.
2. Financing agreements, as provided for under the Commercial Code, were filed by the parties.
3. The treatment of the transaction for state and federal income tax purposes is consistent with the parties’ contention that the agreement is a financing agreement. On the other hand, if the parties have treated the transaction as a sale and leaseback for income tax purposes, this is a clear indication that the parties intended that there be a sale and leaseback of the property. Therefore, if the transaction is intentionally structured by the parties to realize income tax benefits from a sale and leaseback, the intention of the parties that the transaction be given effect in accordance with its form has been clearly established and the transaction will be treated as a sale and leaseback for sales and use tax purposes.
4. The amount which would be attributable to interest had the transaction been structured originally as a financing agreement is not usurious (excessive) under California law. Where a transaction is entered into as a sale and leaseback which would be in violation of the usury provisions of this state if cast in the form of a loan, then the transaction will be given validity in accordance with the express terms of the agreement and will be treated as a sale and leaseback for sales and use tax purposes.
5. In situations where the “lessee” defaulted, the “lessor” resorted to the legal remedies available to a secured party as opposed to legal remedies available to an owner of leased property.

If all the factors as enumerated above are present, then the transaction would qualify as a financing agreement for sales and use tax purposes.

AUDIT OF LEASE TRANSACTIONS WITH GOVERNMENTAL BODIES**0420.50**

Section 6006.3 provides that governmental bodies shall be treated as bound for a fixed term, notwithstanding any right to terminate the contract in the event that sufficient funds are not appropriated, and that these contracts are included in the definition of a “sale under a security agreement.”

If such a contract with a governmental agency is voluntarily terminated by the agency, the agency technically is not in default. However, the seller will be allowed to claim a repossession loss under the guidelines of Regulation 1642, Bad Debts (section 0419.03).

Any transaction regarded under section 6006.3 as a sale under a security agreement with a governmental body, which has been designated as a lease because of budgetary restrictions and which was still active as of January 1, 1987, shall be classified as a sale on that date. This applies to transactions involving both mobile transportation equipment and other tangible personal property.

The sales price that must be reported is the original contract price, net of finance charges, amounts billed for insurance and other non-taxable items. Amounts which were included in the original contract and collected by the lessor/seller will not be considered as additional gross receipts when collected.

Any sales or use tax previously paid on one of these transactions may be credited against any sales or use tax due on that transaction. This credit may be applied only against tax due on the same transaction. If the use tax paid on the “lease” exceeds the tax due on the sale, the taxpayer may file a claim for refund. Audits which include such refunds should follow the instructions regarding refunds (section 0402.20).

When the property is mobile transportation equipment, the sellers (lessors) have been reporting their own use tax liability, measured by fair rental value. Consequently, the sellers (lessors) of mobile transportation equipment are not required to refund to their customers any overpayments of use tax paid on the “leases.”

When the property involved is not mobile transportation equipment, the sellers (lessors) have been collecting and remitting the lessees’ use tax. The amount of use tax paid on each “lease” will be offset against tax due on the sale, on a transaction by transaction basis. In cases where an overpayment has been made, no refund or credit against the seller’s existing liability will be made until the requirements of Regulation 1700 have been met (section 0417.07).

AUDIT MANUAL

AUDIT OF MOTOR VEHICLE FUEL**0430.00****GENERAL****0430.05**

Sales or use tax applies to retail sales of fuel taxed under the Motor Vehicle Fuel License Tax Law. The tax applies to the total selling price of such motor vehicle fuel, *inclusive* of federal and state excise taxes. Sales tax does not apply to retail sales of motor vehicle fuel for use in propelling aircraft, regardless of the fact that it is automotive gasoline. Aircraft jet fuel subject to sales tax unless used on international flights.

Sales or use tax applies to sales of diesel fuel, liquefied petroleum gas (LPG), liquefied natural gas (LNG) and compressed natural gas (CNG). CNG may be exempt if it is delivered to the retailer in gaseous form through pipes or lines from the natural gas supplier and compressed by the retailer. Tax applies to the selling price of the fuel, *inclusive* of federal excise taxes, but *exclusive* of state excise taxes (e.g., Diesel Fuel Tax).

AUDITING PROCEDURE**0430.10**

An inventory reconciliation should be made to verify that recorded purchases include all receipts of motor vehicle fuel, and that metered withdrawals from storage are correctly reported in gallon and dollar amounts (section 0446.10). Total gallons sold times unit selling prices should agree with reported sales of motor vehicle fuel. This accountability procedure should help the auditor determine whether a detailed audit is warranted.

METHODS OF VERIFICATION**0430.15**

Where records are inadequate, it may be necessary to base the verification of sales of motor vehicle fuel on purchases converted to the selling price. Since most service stations sell fuel obtained from one distributor, a schedule of purchases should be obtained from that company, identified as to grade of fuel and gallons involved. If inventories are available, they should be used in computing the net gallons of each grade available for sale.

Unit selling prices should be obtained from the most reliable source available (usually the distributor) and applied to total gallons sold. The resultant sales figures can then be compared with reported sales and a percentage of understatement, if any, computed and applied to sales of motor vehicle fuel reported (section 0446.20).

ACQUISITION OF EX-TAX GASOLINE**0430.20**

While making audits of service stations, auditors should be alert to ex-tax acquisitions of imported gasoline, or stolen gasoline, since the sale of this gasoline is a taxable distribution. Purchase records should be examined to determine whether all fuel was acquired from recognized California distributors, and it should be noted whether the volume of gasoline sold appears to be in balance with the volume of gasoline acquired from recognized California sources. If there are indications that fuel has been acquired illicitly, all available facts should be reported to the Fuel Taxes Division, Special Taxes Department.

AUDIT MANUAL

AUDIT OF MOTOR VEHICLE FUEL RETAILERS — PREPAYMENT OF SALES TAX

0431.00

GENERAL

0431.05

Effective January 1, 2002, wholesalers and suppliers subject to the motor vehicle fuel tax are required to collect prepayments of the retail sales tax from their purchasers on the first removal of fuel at the terminal rack or upon entry into this state and all subsequent transfers of motor vehicle fuel except aviation gasoline in this state. This process continues down to the level of the motor vehicle fuel retailer. Each person making prepayments to suppliers may claim the amount paid as a credit against their sales and use tax liabilities due for the same period. The initial point of imposition was previously on the first distribution of fuel in this state.

All routine audits of motor vehicle fuel sellers must include verification of the accuracy of prepayments made and claimed under the “SG” and sales and use tax programs. Since two separate tax programs and funds are involved, it is critical that audit differences attributable to each program be properly identified and uniformly handled.

REPORTING REQUIREMENTS

0431.10

All retailers of motor vehicle fuel subject to the provisions of the “Prepayment of Sales Tax on Motor Vehicle Fuel Program” should be utilizing a modified sales and use tax return (BOE-401-GS). This return includes a Schedule G (BOE-531-G) which allows the retailer to:

- claim credit for prepayments made on purchases of MVF and
- claim credit for tax paid to other states.

A net figure is carried forward from Schedule G to Line 20 on the face of the sales and use tax return.

AUDITING PROCEDURES

0431.15

A subsidiary schedule will accompany all gasoline retailers’ BOE-414- (Transcript of Returns Filed — Sales and Use Tax). This schedule will reflect amounts reported and claimed on Schedule G of their returns. Such amounts should be verified along with other return amounts. Schedule G must be completely and correctly prepared to ensure proper funding and allocation of tax. Particular attention should be given to:

- **Credit for Sales Tax Prepaid to Fuel Suppliers**
 - All credits claimed must be supported by invoices showing the amount of sales tax prepaid to licensed suppliers or wholesalers. Invoices must show the precollection as a separate amount and include the supplier’s or wholesaler’s “SG” account number. If the “SG” number is not listed on the purchase invoice, it should be verified that the supplier does hold the required “SG” permit. If a separate statement of the precollection is not shown on the invoice, no credit will be allowed. While the proper time to claim the credit is the period in which the purchase has been made (generally, the period in which the invoice date is included), the credit should not be disallowed merely because it was claimed in a subsequent period. It is critical, however, that amounts claimed on the return reconcile to the invoiced amounts.

PROCEDURES WHERE RETAILER IS ALSO A SUPPLIER/WHOLESALE 0431.20

All taxpayers holding an “SG” account will have that account examined in conjunction with their related sales and use tax account.

On occasion a supplier/wholesaler will sell gasoline at retail, claim the prepayment credit on their SG return and not pass the credit on to their retail account. Rather than assessing the “SG” account and crediting the related sales tax account, the auditor should comment on the back of the audit report/FBO or on the front of the BOE–596 under general comments, that a prepayment offset has been allowed. These comments will assist the Refund Section in their reconciliation of the sales tax prepayments on MVF by noting that the problem has been addressed.

Where a supplier/retailer makes their first sale at retail (into the tank of a motor vehicle) and nets the precollection and credit from both the “SG” and sales and use tax return, the auditor need not adjust the return amounts.

LOCAL TAX ALLOCATION 0431.25

Routine audit procedures should be utilized with regard to the examination of the retailer’s reported local tax amounts. Since the “Sales Tax Paid to Fuel Suppliers” credit is taken after the local tax allocation has been computed, no special field procedures are required.

BAD DEBTS 0431.30

Retailers who are not wholesalers or suppliers should have no bad debt credits related to prepayments.

ELIGIBILITY FOR REMOVAL FROM PREPAYMENT STATUS 0431.35

Taxpayers who have requested and been removed from prepayment status on their returns (see sections 6471 and 6471.4), must continue to meet the criteria for removal. It should be verified that the taxpayer continues to qualify: i.e., taxable sales of motor vehicle fuel exceed 75% of their gross receipts. The most recent twelve-month period should be examined. Compliance staff should be advised of those who no longer qualify.

CLOSE-OUTS 0431.40

The credit for prepayments made to suppliers by the seller of a business **cannot** be transferred to the purchaser of that business. Any prepayment credits remaining at the time of closeout should be claimed on the final return.

WORKING PAPERS 0431.45

Audit workpapers will follow procedures similar to those currently used in adjusting a section 6406 tax credit. A separate audit schedule should be prepared for each Schedule G line item requiring correction, indexing each schedule as G, followed by the line number of the item being adjusted (e.g., Schedule G3 — Total Sales Tax Paid). A detailed schedule of differences should also be shown and segregated by month, vendor name and “SG” account number. The audit workpapers showing these differences should accompany the audit report transmitted to headquarters.

Verification comments should include a discussion of what work was done to verify all items related to Schedule G amounts, i.e., repayment of the one-time credit, credit for sales tax paid to wholesalers/suppliers, carry-over of the one-time credit and credit for tax paid to other states.

SPECIAL MOTOR VEHICLE FUEL TRANSACTIONS**0432.00****RETAILERS WHO PREMIX OR BLEND MOTOR VEHICLE FUEL AND LUBE OIL 0432.10**

A retailer who purchases motor vehicle fuel and adds lubricating oil thereby making premixed fuel which they sell as boat fuel to consumers is technically acting as a supplier. Because of the small quantities of premix blended by such retailers, and the insignificant amounts of gasoline tax involved, it is not administratively practical to require them to be licensed as suppliers, post bond, and file monthly returns.

Retailers (usually boat marinas) who purchase motor vehicle fuel and add lubricating oil, thereby making premixed fuel which they sell to consumers are making taxable sales of premix and the entire selling price, including state and federal excise taxes, is subject to sales and use tax.

RETAILERS WHO PURCHASE PREMIX FROM A SUPPLIER**0432.15**

The auditor should see that the manufacturer-supplier of premixed fuel is licensed as a supplier, or that wholesaler-supplier of premix fuel is licensed as a wholesaler.

CREDIT CARD SALES**0432.20**

The service station operator is responsible for sales tax on the retail selling price of all motor vehicle fuel and other products sold or delivered by them unless adequate support is maintained for any deduction claimed. Duplicate credit card invoices generally are acceptable in support of exempt transactions.

MASTER CONTRACT SALES**0432.25**

Some oil companies enter into master sales contracts with consumers to provide motor vehicle fuel and other products for delivery through company-owned or independent operator service stations at specified prices. Examples of this are the contracts the State of California had with some of the major oil companies for motor vehicle fuel and other supplies.

The oil company becomes the retailer of the fuel sold and delivered at the service station level pursuant to the contract and is responsible for the sales tax on such sales. The independent service station operator is making sales for resale and should obtain a resale certificate from the oil company involved to cover such sales.

Generally, contract sales are recorded at the service station level on a credit card invoice at the pump price which includes sales tax reimbursement. The purchaser is billed by the oil company at the contract price plus sales tax reimbursement on the contract price. In reporting and paying tax on these sales, the oil company is not allowed to claim a tax-paid purchases resold credit.

If the independent service station operator receives credit from the oil company for the full amount of the credit card charge, the operator will be receiving credit for sales tax reimbursement. Therefore, in addition to maintaining documentation as to the amount of the sale and the fact that it is a sale for resale, the independent service station operator should have records to show that sales tax reimbursement was not received and retained on any portion of the sale. In some cases, this will consist of a computer listing received from the oil company, at the end of each accounting period reflecting the charge back to the operator of the full amount of sales tax reimbursement on the credit card invoices for master contract sales, and the amount of sales to which the tax applies.

SALES TO THE U.S. GOVERNMENT**0432.30**

Generally these sales are recorded at the service station level on a credit card invoice at the pump price which includes sales tax reimbursement. Since such sales are entirely exempt from sales tax, the service station operator must have documentation to support the deduction. Some oil companies make a charge back to the operator for the amount of the tax. The charge back is supported by a computer printout notifying them of the amount of sales to the U.S. Government included in their credit card sales. The charge back and printout are acceptable as proof of sales to the U.S. Government.

In some instances, the burden of support for these exempt sales may fall entirely upon the operator, in which case reliance would be placed on copies of credit card invoices reflecting that the sale was to the U.S. Government and a reduction of the selling price by the amount of sales tax included. Copies of such credit card invoices are acceptable as support for the deduction. It is anticipated that, if necessary, the oil company credit card department will be able to furnish the local operator with further documentation. In any event, the auditor should insist on adequate support for the deduction.

SALES TO LOCAL GOVERNMENTS**0432.35**

Sales to local government entities (cities, counties, and school districts) are made by local service stations at regular pump prices. With the exception of a few local governments which have participated in the State's master contract, these sales generally are not made pursuant to any negotiated contract, and the service station operator is responsible for reporting and paying the sales tax. Sales to local governments who have participated in the State's master contract should be handled in the same manner as outlined in section 0432.25.

Sales of diesel and special motor vehicle fuels (excludes gasoline) to local governments are exempt from the federal excise tax. However, it is the general practice to bill the total pump price on the credit card sales slip. At the time the credit card invoice is turned into the oil company for credit, the oil company normally credits the operator for the full amount of the invoice, including sales tax. In turn, the oil company bills the local government the price shown on the credit card invoice less the federal excise tax and charges sales tax reimbursement on the net amount. The oil company then claims the credit as a deduction on its federal excise tax return. This results in a reduction in the sales price of the motor vehicle fuel. If the oil company notifies the local service station operator of the amount of federal excise tax not billed to local governments **and** adjusts its credit to the operator for the amount of sales tax thereon, the operator is entitled to adjust his reported gross receipts by the amount of the federal excise tax. If the operator receives credit for the full pump price plus tax thereon, and no adjustment is made, the operator will be held responsible for sales tax on the total amount of the sale since the operator's gross receipts remain unchanged.

Sales of gasoline to local governments are no longer exempt from the federal excise tax.

SALES OF GASOLINE FOR USE IN AIRCRAFT**0432.40**

Sales of gasoline for use in propelling aircraft are exempt from sales tax provided the distribution and sale of the gasoline is subject to the California motor vehicle fuel tax and not subject to refund. Since January 1, 1990, no refund of any motor vehicle fuel tax has been granted for fuel used in propelling aircraft. In recent years there has been increasing use of automotive gasoline to propel small aircraft. The automotive gasoline is normally delivered into the aircraft when sold at an airport, however automobile service stations may sell gasoline for use in propelling aircraft and deliver it into the purchaser's storage containers.

The exemption for gasoline delivered directly into the fuel supply tank of an aircraft may be supported by a properly completed sales invoice or an aircraft exemption certificate. If a sales invoice is used, it must show the purchaser's name and address, the aircraft identification number, the number of gallons sold, the price per gallon, the amount of the sale, and the name and address of the seller. If the aircraft fuel is delivered into the purchaser's storage facilities, the exemption should be supported by an aircraft fuel exemption certificate as well as a sales invoice. A suggested form of an aircraft exemption certificate is included in Regulation 1598.

Gasoline used for inflight testing of aircraft is used for propulsion of aircraft and is exempt from sales or use tax. This exemption applies only to gasoline used for *propelling aircraft*. Gasoline used while the aircraft is *stationary* during construction or during the repair, modification, or maintenance of aircraft is not exempt from the tax.

In years past, aviation gasoline was sometimes used in boats, motor vehicles, and stationary equipment. Because of the high price and limited availability of aviation gasoline, these other taxable uses will rarely be encountered.

SALES TO AIRCRAFT COMMON CARRIERS AND OPERATORS OF WATERBORNE VESSELS

0432.45

Effective July 15, 1991, sales of fuel and petroleum products delivered to the purchasing carriers in California are subject to sales tax except as provided by Regulation 1621(b)(3)(B) for air common carriers. The seller must obtain an exemption certificate (See Regulation 1621) from the common carrier to support the claimed exemption. Between July 15, 1991 and December 31, 2002, a similar exemption existed for water common carriers. The water common carrier exemption was discontinued from January 1, 2003 to March 31, 2004. The exemption was reinstated April 1, 2004 and remains in effect until January 1, 2014.

SALES TO AUTO LEASING FIRMS

0432.50

Sales of gasoline to firms leasing automobiles on a "wet rental" basis are sales for resale when the lease of the automobile is a "continuing sale". A "wet rental" is one in which the total rental charge includes gasoline furnished by the lessor.

If the lessor has paid sales or use tax with respect to their purchase of a leased automobile, or if the lease is of mobile transportation equipment, the lessor is the consumer of gasoline furnished under a "wet rental," unless the sales price of the gasoline is separately stated from the vehicle rental charge.

Sales of gasoline to lessors for resale should be substantiated in the same manner as other sales for resale. Independent service station operators should document such resales on credit card purchases with a resale certificate and a copy of the sales slip or statement showing the amount of the sale.

When a lessee on a "wet rental basis" purchases gasoline and is reimbursed by the lessor, the purchase is subject to sales tax since the service station operator is making a retail sale.

SALES TO LESSORS OF MOBILE TRANSPORTATION EQUIPMENT**0432.55**

Since leases of mobile transportation equipment are not continuing sales or purchases, the lessor is the consumer of the equipment, and is also the consumer of gasoline furnished under a "wet rental" when such lease is not a "sale or purchase" under the law. The lessor is the consumer whether tax was paid on the cost of the equipment or a proper election was made measure their use tax by the fair rental value of the equipment. Fair rental value does not include amounts attributable to furnishing fuel. However, if the lessor holds themselves out as a retailer of the gasoline by separately stating the selling price of the gasoline, plus the sales tax thereon, from the equipment rental charge, they may properly purchase such gasoline for resale.

REFUND OF SALES TAX ON STATE MOTOR VEHICLE FUEL TAX REFUNDS **0432.60**

State motor vehicle fuel tax refunded by the State Controller directly to the consumer is an adjustment to the selling price of the gasoline. A consumer receiving such a refund may also be eligible for a refund under the California Sales and Use Tax Law. The sections of the Sales and Use Tax Law which previously permitted the Controller to refund or collect sales or use tax in connection with these refunds was repealed effective January 1, 1990. Consumers must now claim a refund of the sales and use tax from the retailer and the retailer must claim a refund from the Board.

REFUND OF SALES TAX ON FEDERAL EXCISE TAX REFUNDS**0432.65**

Refunds of the federal excise tax on gasoline, diesel, or jet fuel to consumers may also result in a refund of the sales or use tax measured by the federal tax refund. The rate of federal excise tax refund depends upon the type of off-highway use. Regulation 1598 requires the seller to obtain a certificate from the purchaser if the purchaser is eligible for and receives a refund of or credit for the federal excise tax. The certificate will relieve the seller of liability for collecting sales or use tax on the amount of measure which represents the federal excise tax.

**AUDIT OF FUEL DISTRIBUTORS/BROKERS —
PREPAYMENT OF SALES TAX****0433.00****GENERAL****0433.05**

Fuels subject to the requirement to precollect sales tax include gasoline and gasohol (motor vehicle fuel); diesel, including dyed diesel; and aircraft jet fuel. Wholesalers and suppliers of these fuels are required to collect a prepayment of a portion of the sales tax when they remove fuel at the terminal rack, enter fuel into California, or sell the fuels at any point after removal from the terminal rack. Retailers or other sellers of fuel who have prepaid the sales tax to their suppliers may claim a credit for that prepaid tax when they file their sales and use tax returns.

Each supplier and wholesaler must furnish their customer with a receipt or invoice separately stating the amount of precollected tax. Suppliers and wholesalers are required to show their “SG” account number on their receipts and invoices.

All taxpayers holding an “SG” account, must have this account investigated in conjunction with their related sales and use tax account even though only one or two quarters may be involved. This procedure will facilitate alignment of the “SG” accounts with their related sales and use tax account and ensure that amounts are being properly reported.

Amounts reported under the “SG” program will be posted to a BOE—414—SG Transcript of Returns Filed – SG Fuel Accounts.

PREPAYMENT CREDITS**0433.10**

The amount of prepayment paid by a supplier or wholesaler to their supplier on the purchase of MVF will constitute a credit against the amount required to be collected and remitted to the Board on their prepayment return. Credits are to be taken for the period in which the purchase was made. All credits claimed must be supported by purchase documents, invoices and receipts which separately state the amount of tax prepaid. All purchase documents should be retained in the same manner as other books and records.

AUDITING PROCEDURE**0433.15**

An inventory reconciliation should be made to verify that recorded withdrawals are correctly reported in gallons. Total gallons sold (excluding exempt sales) times the prepayment rate should agree with the reported prepayment of sales tax.

On occasion a supplier/wholesaler will sell gasoline at retail, claim the prepayment credit on their SG return and not pass the credit on to their retail account. Rather than assessing the “SG” account and crediting the related sales tax account, the auditor should comment on the back of the audit report/FBO or on the front of the BOE—596 under general comments, that a prepayment offset has been allowed. These comments will assist the Audit Determination and Refund Section in their reconciliation of the sales tax prepayments on MVF by noting that the problem has been addressed.

Where a supplier/wholesaler makes their first sale at retail (into the tank of a motor vehicle) and nets the precollection and credit from both the “SG” and sales and use tax return, the auditor need not adjust the return amounts.

REPORTING ERRORS**0433.20**

When a notified supplier/wholesaler fails to collect the prepayment on their sale/transfer of MVF subject to the prepayment requirements, but can prove that the full sales tax has been subsequently reported, a notation to that effect should be made in the audit and such amounts should not be determined against the supplier/wholesaler. In such an instance, the supplier or wholesaler should be notified in writing of the precollection requirements. If the supplier/wholesaler has not shown the precollection on the invoice and is unable to prove that the sales and use taxes due have been paid, the amount of unreported precollections should be determined against the supplier/wholesaler.

AUDIT WORKING PAPERS**0433.25**

Schedule numbers should correlate with the line numbers on the "SG" return (e.g., Schedule 2.1 Fuel sold to the United States Government or its agencies and instrumentalities). Audited differences for each line category will be forwarded to a "Summary of Differences" Schedule, 414-SG-1.

Audited differences for "Tax Prepaid to California Vendors," should also be forwarded to Schedule 414-SG-1. A detailed breakdown of audited amounts must be provided by month, vendor name and "SG" account number. This schedule should accompany the audit report sent to the Audit Determination and Refund Section.

BAD DEBTS**0433.30**

A refund of the prepayment may be allowed to any person who is unable to collect the prepayment from the purchaser, insofar as the sales of the fuel are represented by accounts which have been found to be worthless and charged off for income tax purposes. If any of those accounts are thereafter collected by the seller, the gallons of fuel represented by the amounts collected must be included in the next return and the prepayment on those gallons of fuel must be paid to the state.

LOCAL TAX ALLOCATION**0433.35**

No local sales and use tax allocation is involved since no allocation of funds is made until the prepayments are claimed by the retailer.

NEW CAR DEALERS**0433.40**

Many new car dealers importing new vehicles into this state with partially filled fuel tanks are making the first taxable sale of such fuel when the vehicle is sold at retail. Amounts attributable to such importation are generally considered too minimal to warrant registration of such dealers as suppliers under the MVF Tax Law or the "SG" program. However, dealers who purchase gasoline for subsequent retail sale must be coded "G" (MVF retailer) and may require registration as a wholesaler, depending upon the type of operation.

CREDIT OFFSETS**0434.00**

In the following examples, it is irrelevant whether the credit offsets or overpayments were determined on an actual basis or sample examination. (See section 0402.20 for a discussion of the approach to auditing credits or refunds).

CLAIM FOR REFUND FILED WHILE AUDIT DETERMINATION IN PETITION STATUS OR WITHIN SIX MONTHS OF FINALITY DATE**0434.05**

When a claim for refund is filed for overpayments that were made during a period for which an audit determination was issued and the determination is in petition status or the claim is filed within six months of the date that the determination became final, the entire period of the determination is open to a credit offset adjustment. All overpayments made within the period of the determination may be offset against the total liability even if the overpayments are beyond the statutory period of the claim (i.e. three years from the date that the claim is filed). If the total liability is offset, any remaining overpayments within the statutory period of the claim may be refunded to the taxpayer. Only overpayments within the statutory period of the claim may be refunded to a taxpayer. Overpayments outside the statutory period of the claim but within the determination period may only be used to offset liabilities.

Overpayments, beginning with the earliest within the period of the determination, will be applied in the quarter that they occurred without regard to the amount of the quarterly liabilities until the total amount of the liability is offset (Col. C below). If the total liability is offset, any remaining overpayments within the statutory period of the claim may be refunded to the taxpayer (Col. E below). The following example illustrates these procedures.

	(A)	(B)	(C)	(D)	(E)
Periods	Taxable Measure per Audit Determination ¹	Claim for Refund ² (Bad Debts not Claimed)	Offsets ³	Overpayments Outside Statutes ⁴ (Disallowed)	Measure of Tax per Reaudit ⁵ (B-C-D)
2-94	\$15000	\$81000	\$-81000		0
3-94	19000	0	0		0
4-94	30000	0	0		0
1-95	9000	-50000	-50000		0
2-95	5000	-33000	-33000		0
3-95	12000	-40000	-15000	-25000	0
4-95	23000	-44000		-44000	0
1-96	24000	0			0
2-96	10000	-15000			-15000
3-96	13000	0			0
4-96	4000	-22000			-22000
1-97	15000	-10000			-10000
Totals	\$179000	\$-295000	\$-179000	\$-69000	\$-47000

NOTES:

1. Notice of Determination issued on 10/01/98 for the audit period 04/01/94 to 03/31/97. Determination will become final on 10/31/98 or is in petition status.
2. Claim for refund filed 03/01/99 for bad debts not claimed and not adjusted in the audit. Claim for refund timely for statutory period 01/01/96 to 03/31/97. Claim for refund also opens period 04/01/94 through 12/31/95 for offsets to 0.
3. Overpayments starting with the earliest period of the claim applied against the total taxable measure per audit determination until it is completely offset.
4. Remaining overpayments outside statutory period of the claim disallowed.
5. Remaining overpayments within statutory period of claim that are available for refund.

CLAIM FOR REFUND FILED WHEN AUDIT DETERMINATION NOT IN PETITION STATUS OR MORE THAN SIX MONTHS AFTER FINALITY DATE

0434.10

When a claim for refund is filed for overpayments that were made during a period for which an audit determination was issued and the determination is not in petition status and the claim is filed more than six months after the determination became final, only the overpayments made within the statutory period of the claim (i.e. three years from the date that the claim was filed) are available to apply as credit offset adjustments. The overpayments made within the statutory period of the claim may be offset against corresponding quarterly liabilities on a quarter by quarter basis. The overpayments outside of the statutory period of the claim cannot be used to offset liabilities and are disallowed.

Accordingly, the overpayments within the statutory period of the claim will be applied in the quarter that they occurred against corresponding quarterly liabilities (Col. C below). No credit offsets will be made outside of the statutory period of the claim. The following example illustrates these procedures.

	(A)	(B)	(C)	(D)	(E)
Periods	Taxable Measure per Audit Determination ¹	Claim for Refund ² (Bad Debts not Claimed)	Overpayments Allowed ³	Overpayments Outside Statutes ⁴ (Disallowed)	Measure of Tax per Reaudit (A+C)
2-94	\$15000	\$-81000		\$-81000	\$15000
3-94	19000	0		0	1900
4-94	30000	0		0	30000
1-95	9000	-50000		-50000	9000
2-95	5000	-33000		-33000	5000
3-95	12000	-40000		-40000	12000
4-95	23000	-44000		-44000	23000
1-96	24000	0		0	2400
2-96	10000	-15000	\$-15000		-5000
3-96	13000	0	0		1300
4-96	4000	-22000	-22000		-18000
1-97	15000	-10000	-10000		5000
Totals	\$179000	\$-295000	\$-47000	\$-248000	\$132000

NOTES:

1. Notice of Determination for the original audit issued on 08/01/98 for the audit period of 04/01/94 to 03/31/97. Determination became final on 08/31/98.
2. Claim for refund filed 03/01/99 for bad debts not claimed and not adjusted in the audit. Claim for refund timely for refund purposes for statutory period 01/01/96 to 03/31/97. Claim for Refund not timely for offset purposes for period 04/01/94 to 12/31/95.
3. Overpayments within the statutory period of the claim applied against corresponding quarterly liabilities.
4. Overpayments outside statutory period of claim disallowed.

SPLIT BILLINGS

0434.15

When a claim for refund is filed for overpayments that were made during an audit period for which both a phone-in determination and an audit determination were issued, offset rules will apply to each determination separately.

If the claim for refund is filed while the phone-in determination is in petition status or within six months of the date that the phone-in determination became final, the period of the phone-in determination is open to adjustment. Overpayments claimed during this period may be offset against the amount of the phone-in liability even if the overpayments are beyond the statutory period of the claim. If any overpayments remain after the phone-in liability is offset, they may be refunded to the taxpayer *if they are within the statutory period of the claim*. Any remaining overpayments outside of the statutory period of the claim may not be refunded to the taxpayer nor offset against the audit determination. Such remaining overpayments should be disallowed.

Additionally, if the claim for refund is filed while the audit determination is in petition status or within six months of the date that the audit determination became final, the period of the audit determination is open to adjustment. Overpayments claimed during this period, beginning with the earliest, may be offset against the total liability for the audit determination even if the overpayments are beyond the statutory period of the claim. If the total liability of the audit determination is offset, any remaining overpayments *within the statutory period of the claim* may be refunded to the taxpayer. Any remaining overpayments outside the statutory period of the claim may not be refunded to the taxpayer. Such remaining overpayments should be disallowed.

Only overpayments that fall within the period of the phone-in determination, can be offset against that determination. Likewise, only overpayments that fall within the period of the audit determination can be offset against that determination. The following examples illustrate some applications of offsets when a claim for refund is filed timely for audit periods covered by an audit determination but not timely for periods covered by a phone-in determination.

AUDIT MANUAL

**CLAIM FOR REFUND FILED TIMELY FOR AUDIT DETERMINATION
BUT NOT FOR PHONE-IN DETERMINATION**

0434.20

	(A)	(B)	(C)	(D)	(E)	(F)	(G)
Periods	Taxable Measure per Phone-In Determination ¹	Taxable Measure per Audit Determination ²	Claim for Refund (Bad Debts) ³	Offsets ⁴	Overpayments Outside Statutes (Disallowed)	Taxable Measure per Phone-In (A-D)	Taxable Measure per Reaudit ⁵ (C-D-E)
2-94	\$15000		\$-81000	\$0	\$-81000	\$15000	\$0
3-94		19000	0	0			0
4-94		30000	0	0			0
1-95		9000	-50000	-50000			0
2-95		5000	-33000	-33000			0
3-95		12000	-40000	-40000			0
4-95		23000	-44000	-41000	-3000		0
1-96		24000	0				0
2-96		10000	-15000				-15000
3-96		13000	0				0
4-96		4000	-22000				-22000
1-97		15000	-10000				-10000
Totals	\$15000	\$164000	\$-295000	\$-164000	\$-84000	\$15000	\$-47000

Notes:

1. 2-Q-94 liability phoned-in on 07/20/97, determination issued on 07/25/97, and became final on 08/25/97.
2. Waiver was obtained through 10/31/98 and the audit determination was issued on 09/15/98 for the period 07/01/94 to 03/31/97. The determination became final on 10/15/98.
3. Claim for refund filed on 03/01/99. Neither phone-in nor audit determination in petition status. Claim for refund not timely for refunds or offsets for 2-Q-94 liability per phone-in determination (beyond six months of finality date). However, claim for refund is timely for audit determination for purposes of offsets for period 07/01/94 to 12/31/95 and refunds for statutory periods of 01/01/96 to 03/31/97 (within six months of finality date).
4. Overpayments, beginning with the earliest made during the period of the audit determination, applied against the total taxable measure per audit determination until it is completely offset.
5. Balance of overpayments within statutory period of claim that are available for refund.

**APPLICATION OF OVERPAYMENTS TO EXPIRED
LIABILITIES BUT WITHIN THE CLAIM FOR REFUND PERIOD¹****0434.30**

A timely filed Claim for Refund opens up the entire claim period to the assessment of underpaid tax as well as overpaid tax. This is true even if the statute of limitations for part or all of the claim period has otherwise expired. As such, even though the Board of Equalization is barred from issuing a deficiency determination for the expired periods, auditors should apply any underpayments discovered to the verified overpayments up to the point the claim is reduced to zero. Underpayments may be offset against any overpayment period within the claim, not just the period in which the underpayment occurred. However, if an underpayment occurred in an expired period that is not included in the Claim for Refund, it cannot be used to offset any overpayments.

In the following examples, a timely Claim for Refund was received for the period 1Q02-2Q04. Subsequently, based upon the volume of records required to validate the claim, it was decided to audit the taxpayer's records and a waiver for the period 3Q04 & 4Q04 was obtained to protect the statute of limitations. Column C represents the allowable refund measure for each period and Column F represents the additional debit measure disclosed in the audit. Column G is the net debit or credit measure. Column H displays the periods with net credits that may be offset by debit measure from other periods. Credit measure should be offset in the earliest periods first. For example, the credit disclosed in 2Q02 (-\$10,000) should be applied to the 1Q02 liability (\$30,000) and not subsequent liabilities. Doing so minimizes the impact of fluctuations in quarterly debit and credit interest.

In Example 1, total debit measure of \$790,000 is disclosed for the claim period. After the claimed credit amounts are offset by the additional debit measure disclosed, a net credit measure of \$10,000 is remaining for the claim period. This amount is included in Column K, "Measure per Audit" and will be refunded to the taxpayer.

In Example 2, total debit measure of \$830,000 is disclosed for the claim period. Of that amount, \$800,000 is offset by available credits. The balance of \$30,000 cannot be assessed or offset and is excluded from Col K, "Measure per Audit."

¹ California Court of Appeals decision *Sprint Communications Company v. State Board of Equalization* (1995) 40 Cal.App.4th 1254

AUDIT MANUAL

**APPLICATION OF OVERPAYMENTS TO EXPIRED
LIABILITIES BUT WITHIN THE CLAIM FOR REFUND PERIOD**

(CONT. 1) 0434.30

SCHEDULE: 12 A
012-345678
Auditor: J. Smith
01/10/09

EXAMPLE #1: Period of Timely Claim for Refund is 1/1/02 to 6/30/04.

A	B	C	D	E	F	G	H	I	J	K
REF	PERIOD	CREDIT MEAS.	DEBIT MEAS.	DEBIT MEAS.	TOTAL DEBIT MEAS.	NET MEAS.	CREDITS AVAILABLE TO OFFSET OUTLAWED DEBITS	OUTLAWED DEBITS	OFFSETS	MEASURE PER AUDIT
		<12C>	<12D>	<12B>	(D+E)	(C+F)				
1	1Q-02	-100,000	60,000	70,000	130,000	30,000		30,000	-30,000	0
2	2Q-02	-20,000	10,000	0	10,000	-10,000	-10,000		10,000	0
3	3Q-02	-80,000	10,000	30,000	40,000	-40,000	-40,000		40,000	0
4	4Q-02	-50,000	110,000	10,000	120,000	70,000		70,000	-70,000	0
5	1Q-03	-50,000	10,000	60,000	70,000	20,000		20,000	-20,000	0
6	2Q-03	-220,000	10,000	30,000	40,000	-180,000	-180,000		180,000	0
7	3Q-03	-30,000	60,000	140,000	200,000	170,000		170,000	-170,000	0
8	4Q-03	-90,000	120,000	10,000	130,000	40,000		40,000	-40,000	0
9	1Q-04	-40,000	10,000	10,000	20,000	-20,000	-20,000		20,000	0
10	2Q-04	-120,000	20,000	10,000	30,000	-90,000	-90,000		80,000	-10,000
Claim Period Total		-800,000	420,000	370,000	790,000	-10,000	-340,000	330,000	0	-10,000
11	3Q-04	-50,000			0	-50,000	0	0		-50,000
12	4Q-04	-220,000			0	-220,000	0	0		-220,000
13	1Q-05	-30,000			0	-30,000	0	0		-30,000
14	2Q-05	-150,000			0	-150,000	0	0		-150,000
15	3Q-05	0			0	0	0	0		0
16	4Q-05	0			0	0	0	0		0
17	1Q-06	0			0	0	0	0		0
18	2Q-06	0			0	0	0	0		0
19	TOTALS	-1,250,000	420,000	370,000	790,000	-460,000	-340,000	330,000	0	-460,000

There is a net refund for the claim period. All debits may be offset and the net credit amount for the claim period is subject to refund or offset to periods still open under the statutes.

The difference between the totals of Column C and Column F must be equal to either a credit amount or zero (0). It cannot be a debit amount.

The difference between the total of Column C and Column F must equal Column K for the Claim Period (1Q02-2Q04).

The totals in Column K reflect the credit allowed after applying all offsets as well as that portion of the refund for which either a waiver of limitation was secured or the periods are still open under the three year statute.

GENERAL AUDIT PROCEDURES

APPLICATION OF OVERPAYMENTS TO EXPIRED
LIABILITIES BUT WITHIN THE CLAIM FOR REFUND PERIOD

(CONT. 2) 0434.30

SCHEDULE: 12 A
012-345678
Auditor: J. Smith
01/10/09

EXAMPLE #2: Period of Timely Claim for Refund is 1/1/02 to 6/30/04.

A	B	C	D	E	F	G	H	I	J	K
REF	PERIOD	CREDIT MEAS.	DEBIT MEAS.	DEBIT MEAS.	TOTAL DEBIT MEAS.	NET MEAS.	CREDITS AVAILABLE TO OFFSET OUTLAWED DEBITS	OUTLAWED DEBITS	OFFSETS	MEASURE PER AUDIT
		<12C>	<12D>	<12B>	(D+E)	(C+F)				
1	1Q-02	-100,000	60,000	70,000	130,000	30,000		30,000	-30,000	0
2	2Q-02	-20,000	10,000	0	10,000	-10,000	-10,000		10,000	0
3	3Q-02	-80,000	10,000	30,000	40,000	-40,000	-40,000		40,000	0
4	4Q-02	-50,000	110,000	10,000	120,000	70,000		70,000	-70,000	0
5	1Q-03	-50,000	10,000	60,000	70,000	20,000		20,000	-20,000	0
6	2Q-03	-220,000	10,000	30,000	40,000	-180,000	-180,000		180,000	0
7	3Q-03	-30,000	60,000	140,000	200,000	170,000		170,000	-170,000	0
8	4Q-03	-90,000	120,000	10,000	130,000	40,000		40,000	-10,000	0 (1)
9	1Q-04	-40,000	10,000	10,000	20,000	-20,000	-20,000		20,000	0
10	2Q-04	-120,000	20,000	50,000	70,000	-50,000	-50,000		50,000	0
Claim Period Total		-800,000	420,000	410,000	830,000	30,000	-300,000	330,000	0	0
11	3Q-04	-50,000			0	-50,000	0	0		-50,000
12	4Q-04	-220,000			0	-220,000	0	0		-220,000
13	1Q-05	-30,000			0	-30,000	0	0		-30,000
14	2Q-05	-150,000			0	-150,000	0	0		-150,000
15	3Q-05	0			0	0	0	0		0
16	4Q-05	0			0	0	0	0		0
17	1Q-06	0			0	0	0	0		0
18	2Q-06	0			0	0	0	0		0
19	TOTALS	-1,250,000	420,000	410,000	830,000	-420,000	-300,000	330,000	0	-450,000

(1) Offsets can only be applied to debits using credits within the claim period. The available credits during the claim period totalled \$300,000 and the debits disclosed were \$330,000. The remaining debit measure of \$30,000 cannot be assessed due to the statute of limitations. The measure of tax will only include post claim period credits and debits.

The difference between the total of Column C and Column F during the claim period must be equal to either a credit amount or zero (0). It cannot be a debit amount. In the example above, the \$30,000 remaining debit amount on Line 8 was eliminated because there was no remaining credit measure in the claim period.

The difference between the total of Column C and Column F will not equal Column K for the claim period (1Q02-2Q04). The totals in Column K reflect the credit allowed after applying all offsets as well as that portion of the refund for which either a waiver of limitation was secured or the periods are still open under the three year statute.

AUDIT MANUAL

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.
- The Board may grant relief of liability under Revenue and Taxation Code 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 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 the auditor, an eligible taxpayer is provided written and oral instructions to enable the taxpayer to perform the audit verification and prepare the AWP's 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 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. The auditor should consider all reasonable requests for participation, keeping in mind our primary goal is the cost savings in 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 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.

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 on Form BOE-414-Z, *Assignment Contact History*.

(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 described in AM section 0435.10. 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 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 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 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*. 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, the auditor should use 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 agreement will then be signed and dated by the taxpayer and the District Principal Auditor. 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 audit report (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 voids a MAP participation agreement, a summary of the specific circumstances of the case and reasons for voiding the agreement must be provided 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. Upon approval by the appropriate Chief, the District Principal Auditor will send the taxpayer a written notification of the termination of the MAP participation agreement, and the reasons for such termination. The front of the audit report should continue to be marked as MAP 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.

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 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 for evaluation of the MAP.

GLOSSARY OF TERMS**0490.00****ADEQUATE**

Fulfilling minimal requirements; satisfactory; acceptable; sufficient.

ANALYZE

To determine or examine the composition of an item, account or amount, usually by reference to its historical origin; particularly (auditing) to review and set forth in a working paper the details or classified summary of items in an account, obtained or substantiated, where necessary, by reference to sources, and accompanied by explanations of major items and by cross-references to related accounts. See SCAN; VERIFY; AUDIT.

APPROPRIATE

Suitable, desirable, reasonable, or necessary in a particular context; often used by accountants as signifying conformity with the value judgments implicit in current practices. See SIGNIFICANT; PROPER.

APPROXIMATE

Containing error; a quantity or verbal characterization which cannot validly be claimed to coincide in all respects with results which might be secured by more precise treatment.

ARITHMETIC MEAN

The result obtained by dividing the sum of two or more quantities by the number of items; usually denoted by a symbol such as \bar{Y} . It is often intended as a representative quantity or as a measure of the central tendency of a group of items. See AVERAGE; MEAN.

AUDIT

An exploratory, critical review by an auditor of the underlying internal controls and accounting records of a business enterprise or other economic unit, precedent to the expression by him of the opinion of the propriety of its tax returns; often accompanied by a descriptive adjective or phrase indicating scope and purpose.

AVERAGE

1. Arithmetic mean.
2. Any central tendency of a series of quantities.

See ARITHMETIC MEAN; MEDIAN; MODE; WEIGHTED AVERAGE.

AVERAGE DEVIATION

A measure of the variation of a group of numerical data from a designated point; the arithmetic mean of the differences between each item and the arithmetic mean of the data or other selected point where the differences are added without regard to sign. Thus, the arithmetic mean of 5, 6, and 7 is $(5 + 6 + 7)/3 = 6$ and the average deviation, taken without regard to sign, is $(1 + 0 + 1)/3 = 2/3$. The smaller the result the more representative the data. See STANDARD DEVIATION: DISPERSION.

BREAK-EVEN POINT

1. The volume point at which revenues and costs are equal: a combination of sales and costs that will yield a no-profit, no-loss operation.
2. That point in the cost of a variable factor of production at which one or more alternatives are equally economical.

CENTRAL TENDENCY

The pattern displayed by a collection of interrelated data when plotted as coordinates.

CHECK

This is a loose term used in auditing to indicate examination or verification. As a verb, the word has no exact meaning and its use without a descriptive qualification is usually avoided. More descriptive words, such as verify, examine, or prove, are preferable. See TESTCHECK.

CLASSIFICATION

Grouping of transactions, entries, or accounts under a common head or heads; a list of such groupings.

CLERICAL ERROR

As applied to books of account, any incorrect entry or posting, especially when involving routine transactions; typical causes are wrong coding, faulty computation — as in an extension or footing, a failure to enter or post, a posting to a wrong account, and posting to the wrong side of an account.

COMPARE

To establish the correspondence or similarity of differently located items.

CONFIRM

A procedure used to obtain added proof through contracts or communications with independent sources to establish the correctness of situations or transactions; for example, establishing losses of merchandise from fire or theft.

CROSSCHECK

1. To add horizontally as well as vertically in order to assure the accuracy of totals.
2. To perform one operation, as in auditing, which will have the effect of aiding in determining the accuracy, property, or other characteristic of another operation.

DETAILED AUDIT

An examination of the books of account, or a portion thereof, whereby all or substantially all entries and transactions are reviewed and verified, as contrasted with an examination by means of tests or samples. See AUDIT; SAMPLE; TESTCHECK.

DISCREPANCY

Any observed difference between opinions or facts, often with the implication of an error or other impropriety in one or more of them.

DISPERSION

A measure of the variation of a group of numerical data from a central tendency, such as arithmetic mean, by determining the range of such data or their average deviation or standard deviation. See these terms.

EXAMINE

To probe records or inspect securities or other documents, procedures and scope, for the purpose of arriving at opinions of accuracy, propriety, sufficiency, and the like.

INTERNAL CONTROL

This consists of measures and methods employed within an organization to safeguard cash, inventories and other assets as well as to maintain the accuracy and proper functioning of the accounting system. This is of paramount importance in tax auditing since an efficient system of internal control can make the auditor's tests easier and more reliable.

JUDGMENT SAMPLE

A sample whose size and items composing it has been determined by someone who is familiar with the universe undergoing the test and capable of exercising informed and unbiased discretion in making the selection. Such samples are sometimes necessary when data are needed quickly or when interest is confined to only a part of the universe. They are usually less reliable for estimation and prediction purposes than are samples selected on a wholly random basis.

MARKDOWN

The reduction of an originally established selling price.

MARKDOWN CANCELLATION

The portion of original markon restored after a markdown has been made.

MARKON

The amount added to cost, in setting selling prices, to cover operating expenses and profit margin; the ratio to selling price of the amount added to cost, expressed as a percentage; also known as "markup" (see below).

MARKUP

1. The amount added to an established selling price for the purpose of determining a new and higher selling price; the percentage of markup is based on the previously established selling price.
2. The total amount by which established selling prices are increased during a given period in setting new selling prices.
3. = markon.

The Board usage of markup is synonymous with the meaning of markon and is the amount added to cost to obtain the sale price, and generally is referred to in terms of percentages. The percentage of markup is computed by dividing gross profit by cost of sales: $G.P./C.G.S. = \% \text{ of M.U.}$ Businessmen often discuss gross profit in terms of percentages, but seldom discuss markup in these terms. Care should be exercised by auditors to make certain they are on common ground with the taxpayer when discussing gross profit and markup percentages.

MARKUP CANCELLATION

The elimination of a markup or such portion thereof as pertains to referent unsold merchandise. The removal of a previous addition to an established selling price. Markup cancellation is not to be confused with Board's usage of the "markup" definition. See MARKUP.

MARKUP FACTOR

This is the factor by which cost of sales is multiplied to determine total sales: $C.G.S. \times M.U.F. = S$. The markup factor always will be the percentage of markup plus 100%. In computing sales, the markup factor should be used as it saves one step (adding the amount of the markup to cost of sales) in the computation of sales. The markup factor is obtained by dividing sales by cost of sales: $S./C.G.S. = M.U.F.$

MATERIALITY

1. The relative importance or relevance of any item included or omitted from a financial statement, or of any procedure or change in procedure that conceivably might effect such a statement.
2. The characteristic attaching to a statement, fact, or item whereby its disclosure or the method of giving it expression would be likely to influence the judgment of a reasonable person.
3. The relative importance of any audit coverage, such as the testing of certain accounts. The opinion can be reached only by a value judgment on the part of the auditor.

MEAN

A midpoint in an array of numbers. See ARITHMETIC MEAN.

MEDIAN

The central item in a list of numbers arrayed according to size; the value at which on equal number of items fall on either side in a list of numbers so arrayed; often represented by the symbol Md.

MODE

The item of most frequent occurrence in a group of numbers; often represented by the symbol Mo; the class of greatest frequency in a frequency distribution. See MEDIAN; ARITHMETIC MEAN; AVERAGE.

OBJECTIVE

Having a meaning or application apart from the investigator, the peculiarities of his experience, or of the environment, and substantiated or capable of being substantiated by the findings of independent investigators; said of a fact, judgment, or inference; as objective evidence. See SUBJECTIVE.

PRELIMINARY AUDIT

In an initial engagement, the investigation of the business and its accounting system and operating methods preceding the determination of the scope of the audit procedures to be employed.

PROBABILITY SAMPLE

A random sample with a computable sampling error. The computed error indicates the degree of representativeness (or lack thereof) which should be taken into consideration in interpreting the sample results.

PROCEDURAL AUDIT (or REVIEW)

The critical examination by an auditor of internal controls and other procedures employed within an organization, (a) looking at recommendations for their improvement whether by simplification, elaboration, or readaptation, or (b) as a regular feature of a periodic examination. Frequently, the review involves procedures other than accounting.

PROPER

In line with common practice; meeting specifications deemed fitting in the circumstances; ethical as well as legal.

PROVE

To verify or subject to a satisfactory test.

PROVE FOOTINGS

Footings are the sums obtained from vertical or horizontal additions, or both, and are used by the auditor to establish the accuracy of the totals. It usually is sufficient for tax audit purposes to verify the additions on most taxpayer's records to the closest \$100. However, where the footings being verified are used to compute percentages based on tests, they should be verified to the closest dollar.

RANDOM

Arising from chance alone, in contrast with haphazard or systematic. Randomization requires careful planning to make certain that only chance elements are present, or that bias, if present or introduced, is known and measurable.

RANDOM NUMBERS

A set of numbers formed at random; generally arrayed in tabular form to assist in sample selection.

RANDOM SAMPLE

A sample in which all the elements have been drawn at random, or according to the laws of chance. The procedure by which the sample is constructed characterizes a random sample, rather than its specific content. See STRATIFIED SAMPLING; SYSTEMATIC SAMPLING; REPLICATION.

RANDOM VARIATION

A fluctuation resulting from chance alone.

RANGE

The difference between the largest and smallest items in a group of numerical data. See DISPERSION.

RECONCILE

To account for difference between separate sources of information for the same transaction. The tax auditor often will be confronted with differences between the taxpayer's records, tax work sheets, and returns filed.

RELIABILITY

1. (Auditing) The measure of confidence that may be placed in a set of records or reports. See REPLICATION.
2. (Statistics) Relative ability to repeat results in a given set of trials or experiments.

REPLICATION

The repetition of methods by which evidence is gathered. Thus, if under similar conditions of selection and verification, two independent examinations are made of a group of vouchers, each is a replication of the other, although the particular vouchers examined may not be the same.

The replication of audit methods may be regarded as a test of precision with which the procedures were carried out. See VALIDITY.

REPRESENTATIVE SAMPLE

Any random sample selected for observation, whether or not containing a determinable error. See PROBABILITY SAMPLE.

REVIEW

To examine critically any operation, procedure, condition, event, or series of transactions.

SAMPLE

A portion of a group of related transactions, financial statements, or other universe of data chosen to reflect or assist in determining the accuracy, propriety, or other characteristics of the whole. Sampling is an important element in the process of auditing. See TESTCHECK.

SAMPLING ERROR (Statistics)

Standard error of a sampling distribution.

SCAN

To look at the entries in an account, accounting record, or a group of accounts or records, for the purpose of testing general conformity to pattern, noting apparent irregularities, unusual items, or other circumstances appearing to require further study. The term indicates a general and rapid review as opposed to a detailed examination or substantiation of each item, and often a review requiring the skill of a practiced auditor and having as its purpose the discovery of the qualitative aspects of a procedure, classification, or account. See ANALYZE.

SCOPE

The character of an audit, primarily with reference to the procedures utilized in a particular audit, or the extent to which the transactions, records, or accounts examined serve as a basis of adequate testing and substantiation.

SHELF TEST

This is a general term for procedures used to determine the unit price of merchandise sold. In many instances, this is done by examining unit prices of merchandise on the shelves of the retailer. Unit sales prices also may be determined by examining catalogs, sales tickets, menus, contracts, etc.

SIGNIFICANT

1. Of sufficient magnitude, as measured by a departure from some norm or standard, to raise doubt that the deviation is the result of chance, random, or compensating factors; hence, indicating behavior calling for a better awareness or understanding of the cause, the removal of the cause, or a modification of the standard because of its inadequacy.
2. Of sufficient importance to warrant disclosure or the treatment accorded larger or more important items; likely to influence judgments or decisions; said of individual transactions, transaction groups, or other events or conditions peculiar to a given establishment.

SIGNIFICANT AMOUNT

A rounded-off number, as of dollars, conveying to the observer the same impression as would the fully expressed quantity.

SPECIAL AUDIT

An audit, having a special or general scope, for other than the regular periods or for other than customary purposes; a limited audit. See AUDIT.

STANDARD DEVIATION (Statistics)

A measure of dispersion: the square root of the average of the squares of the differences between a group of numbers and their arithmetic mean.

While other measures of dispersion, such as range and average deviation, are available, the preferred measure of dispersion in statistics is the standard deviation.

STATISTIC

Any value, such as an arithmetic mean, median, or standard deviation, calculated from a sample rather than a universe.

In accounting practice, "statistics" are sometimes distinguished from accounting data by the fact that the former may not tie in directly with the books of account and thus be subjected to the discipline of double-entry bookkeeping.

STRATIFIED SAMPLING (Statistics)

Drawing of random samples within strata of relatively homogeneous subgroups of the population. Generally, the strata are sampled independently so that sample results in one strata do not affect sampling procedures in other strata. The data may also be classified into strata on the basis of cost, ease, facility of handling materials, and other criteria, as well as statistical homogeneity.

SUBJECTIVE

Having a meaning or application reflecting the characteristics of the investigator, the peculiarities of his experience, or of the environment, and not substantiated by independent investigators: said of a fact, judgment, or inference.

SUBSTANTIATE

To insure the accuracy of, by weight of evidence; to verify.

SYSTEMATIC SAMPLING (Statistics)

A sample design or set of sampling procedures, frequently employed, wherein sampling units are selected at some fixed and designated interval, e.g., every fifth file card in a file system. A systematic sample qualifies as a random sample if the starting element is selected at random and every k th element (k , an integer) of the frame is selected thereafter.

TEST

1. A specified procedure or set of procedures, including rules or assembling evidence, interpretation, and significance for accepting or rejecting hypotheses.
2. As applied to the quality of a commodity or of a performance, a sample or sampling.

TESTCHECK

To verify selected items in an account or record for the purpose of arriving at an opinion of the correctness of the entire account or record; to sample. See SAMPLE; TEST.

TESTED

Records are examined to the extent deemed appropriate.

TESTING

The justification for testing rests largely upon the probability that irregularities are recurrent; that, once committed, they will be reported.

TRACE

To ascertain whether an item has been disposed of in accordance with source indications. The tracing of transactions is a necessary phase of the tax auditor's verification and is particularly important when establishing differences in test periods.

UNIVERSE

1. The whole of the subject matter of whatever is under consideration.
2. (Statistics) The entire matrix or group of data from which samples may be drawn; sometimes referred to as a population.

VALIDATE

1. To test for or to certify or attest to accuracy, precision, reliability, and relevance.
2. To do what is necessary to make effective or legal.

VALIDITY

As used in deductive logic; propriety established by a strong inference in which no inconsistency appears.

VERIFICATION

1. The procedure by which validity is ascertained.
2. The process of substantiation involved in providing by customary audit procedures that a statement, account, or item is accurate and properly stated, or to be within permissible or reasonable limits.

VERIFICATION OF POSTINGS

Verification of postings involves tracing original records to the books or original entry whose totals are then traced to postings in the general ledger.

VERIFY

To confirm the truth, accuracy, or probability of, by competent examination; to substantiate.

WEIGHTED AVERAGE

A simple average of items reduced to a common basis.

ACKNOWLEDGMENT

The principal source of the definitions included in this glossary appears below:

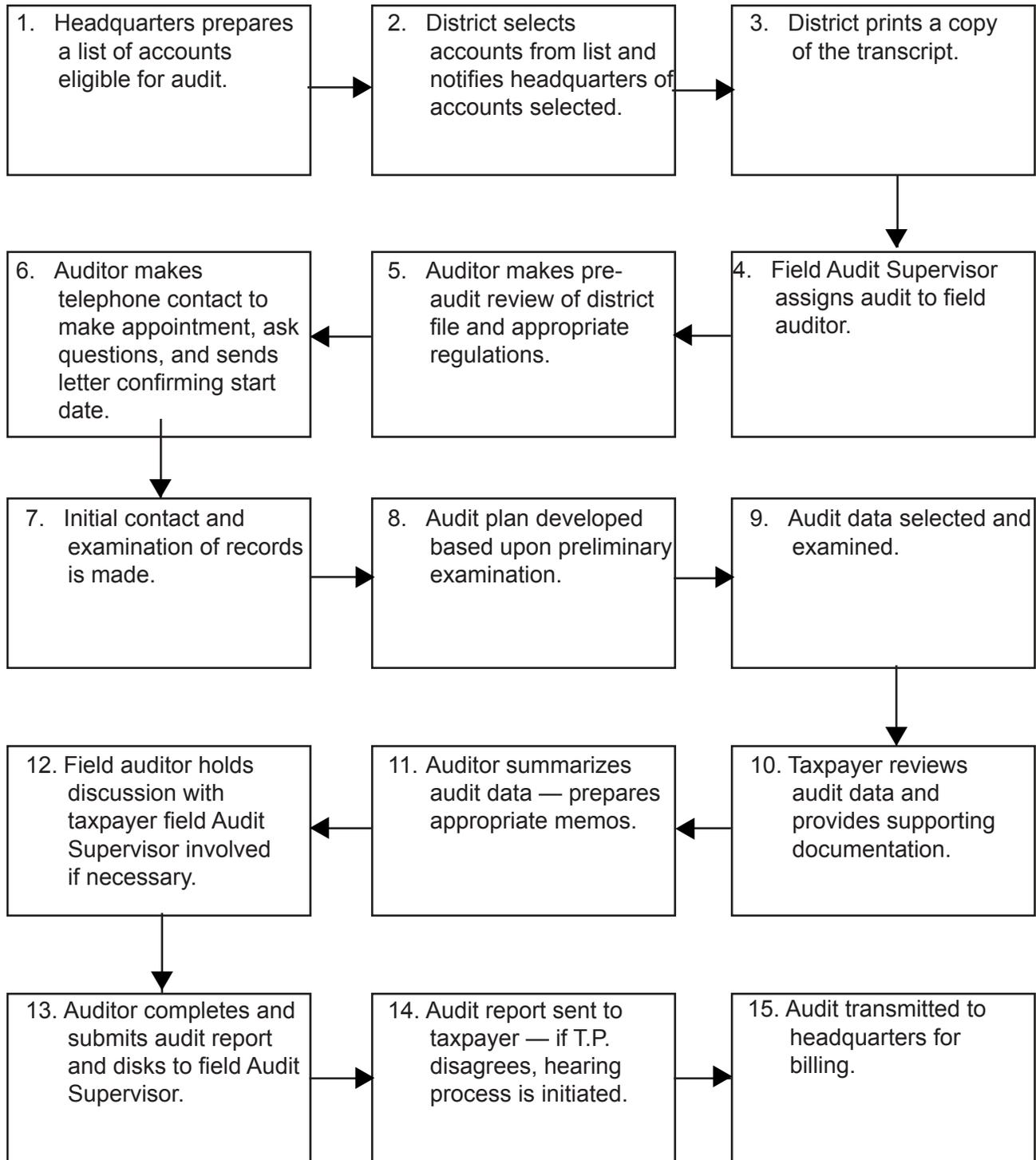
Eric L. Kohler, A DICTIONARY FOR ACCOUNTANTS,
3rd Ed., (C) 1963. Reprinted by permission of
Prentice-Hall, Inc., Englewood Cliffs, New Jersey.

Table of Exhibits

AUDIT PROCESS FLOW CHART.....	EXHIBIT 1
FORM BOE-1164 — AUDIT MEMORANDUM OF POSSIBLE TAX LIABILITY	EXHIBIT 2
FORM BOE-1032 — INFORMATION ON OUT-OF-STATE RETAILERS.....	EXHIBIT 3
POLICY AND PROCEDURE FOR SUBPOENA REQUESTS.....	EXHIBIT 4
FORM BOE-472 — AUDIT SAMPLING PLAN	EXHIBIT 5
EXAMPLES OF PRIOR AUDIT PERCENTAGE MEMOS.....	EXHIBIT 6
SAMPLE SALES TAX WORKING PAPER (WHOLE DOLLAR AUDITING)	EXHIBIT 7
FORM BOE-503-A/B/C — ABC LETTER PROCEDURE.....	EXHIBIT 8
FORM BOE-504-A/B/C — XYZ SAMPLE LETTER.....	EXHIBIT 9
FEDERAL ACQUISITION REGULATIONS (FAR's) CLAUSE DEFINITIONS	EXHIBIT 10A
FEDERAL ACQUISITION REGULATIONS (FAR's) PROGRESS PAYMENTS	EXHIBIT 10B
FEDERAL ACQUISITION REGULATIONS (FAR's) GOVERNMENT PROPERTY (FIXED PRICE CONTRACTS).....	EXHIBIT 10C
FEDERAL ACQUISITION REGULATIONS (FAR's) GOVERNMENT PROPERTY (COST REIMBURSEMENT, TIME-AND-MATERIAL, OR LABOR-HOUR CONTRACTS).....	EXHIBIT 10D
FEDERAL ACQUISITION REGULATIONS (FAR's) SPECIAL TOOLING.....	EXHIBIT 10E
FEDERAL ACQUISITION REGULATIONS (FAR's) SPECIAL TEST EQUIPMENT	EXHIBIT 10F
SAMPLE AUDIT PROGRAM.....	EXHIBIT 11
FORM BOE-837 — AFFIDAVIT FOR SECTION 6388 OR 6388.5 EXEMPTION	EXHIBIT 12
FORM BOE-526 — MANAGED AUDIT PROGRAM PARTICIPATION AGREEMENT	EXHIBIT 13
FORM BOE-52 — CERTIFICATE OF VERIFICATION OUT OF STATE DELIVERY	EXHIBIT 14
FORM BOE-52-L — SAMPLE LETTER, SELLER RECEIPT OF GOODS IN INTERSTATE COMMERCE.....	EXHIBIT 14A
FORM BOE-52-L1 — SAMPLE LETTER, AUDITOR	EXHIBIT 14B
FORM BOE-52-L2 — SAMPLE LETTER FOR SELLER NOTICE OF PENDING REFUND OF EXCESS SALES TAX REIMBURSEMENT.....	EXHIBIT 14C
SAMPLE MEMO, REPORT OF SUSPECTED MONEY LAUNDERING ACTIVITY	EXHIBIT 15

AUDIT PROCESS FLOW CHART

EXHIBIT 1



GENERAL AUDIT PROCEDURES

FORM BOE-1164 — AUDIT MEMORANDUM
OF POSSIBLE TAX LIABILITY

EXHIBIT 2

BOE-1164 REV. 13 (10-03)

AUDIT MEMORANDUM OF POSSIBLE TAX LIABILITY

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

TO _____ — Auditing	FROM _____ — Auditing
<input type="checkbox"/> BUYER'S — FILE	<input type="checkbox"/> SELLER'S — FILE
ACCOUNT NO. _____	ACCOUNT NO. _____
NAME _____	NAME _____
STREET _____	STREET _____
CITY _____ STATE/ZIP CODE _____	CITY _____ STATE/ZIP CODE _____
PHONE _____ ()	PHONE _____ ()

NOTE: Check one or more blocks as appropriate and line out inapplicable words in parenthesis.

Records of the (buyer) (seller) show the following questioned transactions:

- Tax assessed in audit of (buyer) (seller) Period _____ to _____
- Seller has valid (resale) (exemption) certificate from buyer on file (*Attach photocopy of certificate to BOE-1164*)
- (Buyer) (Seller) states that a (resale) (exemption) certificate (was) (was not) given
- (Resale) (Exemption) certificate was issued by the buyer for tools and supplies
- (Sales) (Use) tax was remitted to seller when paying the indicated ex-tax invoices
- Tax (not added) (incorrectly computed)
- Other (*describe*) _____

ATTACH COPIES OF INVOICES OR SCHEDULE ITEMS BELOW

Date	Invoice No.	Purchase Order No.	Amount	Description of Merchandise	Shipped From

See attached invoices and/or schedule.

Above listing covers Period _____ to _____ Sample Listing

COMMENTS AND RECOMMENDATIONS

AUDITOR _____	AUDITOR PHONE _____ ()	DATE _____
---------------	-------------------------------	------------

Prepare in duplicate and give original to supervisor. Duplicate to be retained with audit. (Refer to A.M. Sections 0401.20 and 0408.20)

BOE-1032 REV. 5 (2-03)

INFORMATION ON OUT-OF-STATE RETAILERS

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

TO: Out-of-State Compliance

Date _____

SUBMITTED BY: District Office _____

Auditor _____ Auditor Phone _____

Short Form Option:

(Check this box and attach a copy of the invoice in lieu of completing the entire 1032 form. However, please complete items 3 and 8 if known, and check the appropriate box on line 6(b).)

1. Out-of-State Retailer (or vendor)

Name _____

DBA _____

Street _____

City, State and Zip _____

Phone Number _____

2. Purchaser (or buyer)

Name _____

Account Number _____

Street _____

City _____

Phone Number _____

3. Sales Representative (who solicited sale)

Name _____

Account Number _____

Address _____

City and State _____

4. Date of Invoice _____

5. Invoice Number _____

6(a). Amount of Purchase (attach copy of invoice) _____

6(b). Use Tax Paid by Purchaser or Included in Audit Yes No

7. Description of Property Sold _____

8. How Sale Was Solicited _____

9. Other Information _____

All items should be completed.
(Refer to A.M. Section 0408.22)

POLICY AND PROCEDURE FOR SUBPOENA REQUESTS SUBPOENAS DUCES TECUM

Authority and Use. The Board of Equalization is authorized by Section 15613 of the Government Code to issue a subpoena for the attendance of witnesses or the production of books, records, accounts and papers. A subpoena requiring a person to bring books, records, accounts and papers with them is called a “subpoena duces tecum.” When in the course of a field audit or investigation of a taxpayer’s business, the Board’s representative is denied access to business records which are necessary in order to carry out the functions of the Board, the subpoena power may be invoked. The subpoena should be considered only when the records are known or believed to exist, the potential liability to be revealed by the records is significant, and all other methods of obtaining the records have been unsuccessful.

Procedure. All subpoenas will be prepared by the Legal Department in Headquarters utilizing information provided by the district. Districts should prepare the request in the form of a memorandum from the District Administrator to the Chief, Field Operations Division or the Chief, Collections and Third District Operations Division. The Chief, Field Operations Division or the Chief, Collections and Third District Operations Division will forward approved requests to the Legal Department for drafting and issuance.

Information Needed. The memorandum should include the following information:

- a) The taxpayer(s) name, dba(s), address, and tax number(s) applicable to the records being requested.
- b) The name and address of the person or entity upon whom the subpoena is to be served.
- c) The name and title of the Board employee who will examine the documents.
- d) The Board address where the documents are to be examined.
- e) If necessary, a date and or time when the records are to be produced or examined. A date/ time may be appropriate if the employee who will examine the records will be available only before or after a certain date. Normally the Legal Division will calculate and specify the appropriate dates based on time frames which are controlled by statute.
- f) The time period covered by the documents that are being requested.
- g) The specific documents that are being requested. Request only the records needed for the audit. Do not state “any and all records” or similar omnibus requests.
- h) The efforts that have already been made to obtain the documents being sought. Attach copies of letters written, and indicate whether the request was ignored or refused.

- i) If service is being made on a financial institution for production of a customer's financial records, the California Right to Financial Privacy Act requires that the customer affected also be served with a copy of the subpoena, and have a period of time in which to notify the financial institution of intent to move to quash the subpoena. Therefore, the following additional information is required:
- customer's name, address, and account number at the financial institution
 - character of the customer —
 - corporation
 - corporation that has forfeited its charter or right to do business or that has dissolved
 - joint stock company or association
 - partnership
 - unincorporated association
 - public entity
 - minor
 - fiduciary — guardian, conservator, trustee, executor, etc.
 - candidate for election for public office
 - any other natural person not described above.

The above information is necessary in order that the subpoena and the declaration of materiality under penalty of perjury supporting the issuance of the subpoena may be prepared with the degree of particularity necessary to insure against infringements of the taxpayer's constitutional guarantees relating to unreasonable search and seizure and due process of law.

Preparation and Service of Subpoena and Declaration. The Legal Division will prepare the Subpoena Duces Tecum, Declaration, Notices and Acknowledgment of Receipt, and Proofs of Service. The documents will be sent to the District Administrator together with complete instructions for serving the subpoena. Subpoenas being served on financial institutions for the production of customer records include instructions to the financial institution to estimate and obtain approval of their research and copying charges before complying with the subpoena. The instructions provided by Legal must be followed exactly to protect the rights of both the taxpayer and the Board.



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
 SALES AND USE TAX DEPARTMENT
 450 N STREET, SACRAMENTO, CALIFORNIA
 PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-00XX
 916-XXX-XXXX • FAX 916-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

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.

BOE-472 (S2F) REV. 4 (12-03)
AUDIT SAMPLING PLAN

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

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:

See AM sections 1302.10 and 1302.15,

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:

The sample period and a complete list should be made of all possible records that may be necessary to make all decisions regarding the correctness of the test items. See AM section 1302.15. For example, "Sales for resale for the period of XX to YY."

- a) Filing method used for the population:

3. The sampling unit will be:

The sampling unit is the item being selected for review: i.e., a period of time, transactions (sales invoice, check, purchase invoice, etc.), clusters, etc.

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

For example, block sampling, statistical sampling with random selection, systematic statistical sample with random start, cluster sample, etc. See AM section 1304.00

GENERAL AUDIT PROCEDURES

BOE-472 (S2B) REV. 4 (12-03)

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:

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

5. The statistical sample size will be:

Indicate the number of sample units. See AM section 1303.00

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

See AM sections 0405.20(c) and 1303.00

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

7. The sample base will be:

Units: _____

Dollars: _____

BOE-472 (S3F) REV. 4 (12-03)

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:

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):

Indicate whether duplicate sample unites will or will not be replaced with another sample unit.

b) Missing sample unit(s):

See AM sections 1302.25(g)

GENERAL AUDIT PROCEDURES

BOE-472 (S3B) REV. 4 (12-03)

TAXPAYER NAME	SCHEDULE NUMBER
AUDIT PERIOD to	ACCOUNT NUMBER

c) Sample unit is a void or canceled transaction:

See AM sections 1302.25(e) and (f)

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

See AM sections 1302.25(f)

e) Sample unit is a "credit" item:

See AM sections 1302.25(f)

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

See AM sections 1302.25(d)

g) Sample unit is for "tax" only:

See AM sections 1302.25(f)

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

See AM sections 1302.25(f)

BOE-472 (S4) REV. 4 (12-03)

TAXPAYER NAME	SCHEDULE NUMBER
AUDIT PERIOD to	ACCOUNT NUMBER

11. Other:

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

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.

cc: I. M. Auditor

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

GENERAL AUDIT PROCEDURES

**SAMPLE SALES TAX WORKING PAPER
(WHOLE DOLLAR AUDITING)**

EXHIBIT 7

WHOLE DOLLAR AUDITING
(schedule name)

SRAC 12-121212
J.C. Conlon
09/09/99

	A	B	C	D	E	F	G	H
	(B+C)			<414>	(D-E)		<C>	
REF	PERIOD	SALES PER RECORDS	AUDITED SALES OF FIXED	TOTAL AUDITED SALES	REPORTED	DIFFERENCE	Analysis of Differences	
							W/D VARIANCES	SALE OF ASSET
1								
2	2-xx	428,465		428,465	428,466	-1	-1	0
3	3-xx	475,150		475,150	475,145	5	5	0
4	4-xx	367,481	10,000	377,481	367,482	9,999	-1	10,000
5		<u>1,271,096</u>	<u>10,000</u>	<u>1,281,096</u>	<u>1,271,093</u>	<u>10,003</u>	<u>3</u>	<u>10,000</u>
6								
7								
8								
9								
10								
11								
12								
13								
14								
15								
16								
17								
18								
19								
20								
21								
22								
23								
24								
25								
26								
27								
28								
29								
30								
31								
32								
33								
34								
35								
36								
37								
38								
39								
40								

COPY PROVIDED TO TAXPAYER
DATE _____



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.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

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

SAMPLE LETTER
Requesting Vendor's Statement

ABC Company
1234 5th Street
Any Town, CA 90000

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 by you, as covered by the invoices listed on the attached sheet.

Since the Board audits both the seller and the purchaser, it is very important that you respond to the enclosed document in order to assure that tax is assessed only once on each transaction.

Would you please review the enclosed document and complete the appropriate portions of it. As noted on the document, you may need to check more than one box for a transaction. 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 for us to determine if tax has been paid on this/these transactions. Please return the enclosed document within 10 days using the enclosed envelope or fax to (____) _____.

SAMPLE

BOE-503-C REV. 1 (8-99)

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

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

DMA _____

Auditor's Initials _____

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

NAME OF CUSTOMER TO WHOM YOU SOLD ITEMS WITHOUT USE TAX

Invoice Date	Invoice Number	Amount	Description	Response List all boxes (a) through (g) that apply

Please mark all applicable boxes below and list in response area above.

- a. The tax was paid directly to the Board of Equalization as a result of an audit determination dated _____ covering the period _____ to _____. The Board's audit specifically included the above transaction in the audit assessment.
- b. The tax was paid directly to the Board of Equalization as a result of an audit determination dated _____ covering the period _____ to _____. The Board's audit examined our sales on a test basis with a percent of error computed and applied. The sales sampled in the audit were similar in nature to the above transaction. Accordingly, as a result of this audit we believe tax on the above transaction has been paid to the Board.
- c. The Board of Equalization is in the process of auditing our company for the period _____ to _____. The Board is examining our sales to California customers. Accordingly, as a result of this audit we believe that tax on the above transaction(s) may be questioned by the Board.
- d. I was engaged in business in the special tax district where the sold property was shipped or delivered and tax was or will be assessed as part of an audit by the Board of Equalization. This option should be used in conjunction with Item a, b or c above.
- e. The property described on the above listed invoices was shipped from the city of _____ in the State of _____.
- f. No sales or use tax was charged by our company on the above questioned document(s), however, the tax was reported and remitted by our company to the Board of Equalization on our tax return for the period _____.
- g. Our company has not paid the California sales or use tax to the Board of Equalization and we have not been audited for the same period for the transactions listed above.

COMMENTS

SELLER'S PERMIT NO.	SELLER'S NAME
SIGNATURE	TELEPHONE NO.
TITLE (Owner, Partner, President, etc.)	DATE

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



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 (____) _____.

GENERAL AUDIT PROCEDURES

(CONT.) EXHIBIT 9

Page 3 of 9

BOE-504-C REV. 12 (1-97)

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

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

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

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.

BOE 504-CLS (1-97)
**STATEMENT CONCERNING PROPERTY PURCHASED
WITHOUT PAYMENT OF CALIFORNIA SALES TAX**

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

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.

BOE-504-BPA (11-02)

STATE OF CALIFORNIA
BOARD OF EQUALIZATIONSAMPLE LETTER FOR SPECIAL PRINTING AIDS
Requesting Purchaser's StatementXYZ 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:

BOE-504-CPA REV. 3 (4-03)

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

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

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.
--	---------------------

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.

GENERAL AUDIT PROCEDURES

BOE-504-CFS REV. 1 (9-02)

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

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

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

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

BOE 504-CUS (1-97)

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

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

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.

GENERAL AUDIT PROCEDURES

(CONT.) EXHIBIT 9

Page 9 of 9

BOE 504-COS (1-97)

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

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

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.

**FEDERAL ACQUISITION REGULATIONS (FAR'S)
CLAUSE DEFINITIONS****EXHIBIT 10A**
Page 1 of 2**FAR CLAUSE DEFINITIONS****31.001. Definitions.**

Cost objective - a function, organizational subdivision, contract, or other work unit for which cost data are desired and for which provision is made to accumulate and measure the cost of processes, products, jobs, capitalized projects, etc.

31.202. Direct Costs.

- (a) A direct cost is any cost that can be identified specifically with a particular final cost objective. No final cost objective shall have allocated to it as a direct cost any cost, if other costs incurred for the same purpose in like circumstances have been included in any indirect cost pool to be allocated to that or any other final cost objective. Costs identified specifically with the contract are direct costs of the contract and are to be charged directly to the contract. All costs specifically identified with other final cost objectives of the contractor are direct costs of those cost objectives and are not to be charged to the contract directly or indirectly.
- (b) For reasons of practicality, any direct cost of minor dollar amount may be treated as an indirect cost if the accounting treatment -
 - (1) Is consistently applied to all final cost objectives: and
 - (2) Produces substantially the same results as treating the cost as a direct cost.

31.203. Indirect Costs.

- (a) An indirect cost is any cost not directly identified with a single, final cost objective, but identified with two or more final cost objectives or an intermediate cost objective. It is not subject to treatment as a direct cost. After direct costs have been determined and charged directly to the contract or other work, indirect costs are those remaining to be allocated to the several cost objectives. An indirect cost shall not be allocated to a final cost objective if other costs incurred for the same purpose in like circumstances have been included as a direct cost of that or any other final cost objective.
- (b) Indirect costs shall be accumulated by logical cost groupings with due consideration of the reasons for incurring such costs. Each grouping should be determined so as to permit distribution of the grouping on the basis of the benefits accruing to the several costs objectives....
- (c) Once an appropriate base for distributing indirect costs has been accepted, it shall not be fragmented by removing individual elements....

31.205-26. Material Costs.

- (a) Material costs include the costs of such items as raw materials, parts, sub-assemblies, components, and manufacturing supplies, whether purchased or manufactured by the contractor, and may include such collateral items as inbound transportation and intransit insurance....

45.101. Definitions.

Government-furnished property - property in the possession of, or directly acquired by, the Government and subsequently made available to the contractor.

Government property - all property owned by or leased to the Government or acquired by the Government under the terms of the contract. It includes both Government-furnished property and contractor-acquired property as defined in this section.

Special test equipment - either single or multi-purpose integrated test units engineered, designed, fabricated, or modified to accomplish special purpose testing in performing a contract. It consists of items or assemblies of equipment, including standard or general purpose items or components that are interconnected and interdependent so as to become a new functional entity for special testing purposes. It does not include material, special tooling, facilities (except foundations and similar improvements necessary for installing special test equipment), and plant equipment items used for general plant testing purposes.

Special tooling - jigs, dies, fixtures, molds, patterns, taps, gauges, other equipment and manufacturing aids, all components of these items, and replacements of these items, which are of such a specialized nature that without substantial modification or alteration their use is limited to the development or production of particular supplies or parts thereof or to the performance of particular services. It does not include material, special test equipment, facilities (except foundations and similar improvements necessary for installing special tooling), general or special machine tools, or similar capital items.

FEDERAL ACQUISITION REGULATIONS (FAR'S)
PROGRESS PAYMENTS

EXHIBIT 10B

CODE OF FEDERAL REGULATIONS
TITLE 48
FEDERAL ACQUISITION REGULATIONS SYSTEM

52.232-16

Progress Payments

(Formerly ASPR 7-104.35)

Effective April 1, 1984
Amended August 1987

The contracting officer shall insert 52.232-16 in solicitations and fixed-price contracts under which the Government will provide progress payments based on costs.

52.232-16

(d) Title.

- (1) Title to the property described in this paragraph (d) shall vest in the Government. Vestiture shall be immediately upon the date of this contract, for property acquired or produced before that date. Otherwise, vestiture shall occur when the property is or should have been allocable or properly chargeable to this contract.
- (2) Property, as used in this clause, includes all of the below-described items acquired or produced by the Contractor that are or should be allocable or properly chargeable to this contract under sound and generally accepted accounting principles and practices.
 - (i) Parts, materials, inventories, and work in process;
 - (ii) Special tooling and special test equipment to which the Government is to acquire title under any other clause of this contract;
 - (iii) Nondurable (i.e., noncapital) tools, jigs, dies, fixtures, molds, patterns, taps, gauges, test equipment, and other similar manufacturing aids, title to which would not be obtained as special tooling under subparagraph (ii) above; and
 - (iv) Drawings and technical data, to the extent the Contractor or subcontractors are required to deliver them to the Government by other clauses of this contract.
- (3) Although title to property is in the Government under this clause, other applicable clauses of this contract, e.g., the termination or special tooling clauses, shall determine the handling and disposition of the property.
- (4) The Contractor may sell any scrap resulting from production under this contract without requesting the Contracting Officer's approval, but the proceeds shall be credited against the costs of performance.
- (5) To acquire for its own use or dispose of property to which title is vested in the Government under this clause, the Contractor must obtain the Contracting Officer's advance approval of the action and the terms. The Contractor shall (i) exclude the allocable costs of the property from the costs of contract performance, and (ii) repay to the Government any amount of unliquidated progress payments allocable to the property. Repayment may be by cash or credit memorandum.
- (6) When the Contractor completes all of the obligations under this contract, including liquidation of all progress payments, title shall vest in the Contractor for all property (or the proceeds thereof) not -
 - (i) Delivered to, and accepted by, the Government under this contract; or
 - (ii) Incorporated in supplies delivered to, and accepted by, the Government under this contract and to which title is vested in the Government under this clause.

FEDERAL ACQUISITION REGULATIONS (FAR'S)
GOVERNMENT PROPERTY (FIXED PRICE CONTRACTS)

EXHIBIT 10C
Page 1 of 2

CODE OF FEDERAL REGULATIONS
TITLE 48
FEDERAL ACQUISITION REGULATIONS SYSTEM

52.245-2

Government Property (Fixed-Price Contracts)
(Formerly ASPR 7-104.24)

Effective April 1, 1984

Amended December 1989

The contracting officer shall insert 52.245-2 in solicitations and contracts when a fixed-price contract is contemplated, unless (1) the acquisition cost of all Government-furnished property to be involved in the contract is \$50,000 or less (excluding contracts with educational or nonprofit organizations) or (2) when the cost of the property furnished does not exceed \$10,000 for purchase orders for property repair.

If the contract is a fixed-price service contract which is performed primarily on a Government installation, the contracting officer shall use the clause with its Alternate I.

If the contract is for the conduct of basic or applied research at nonprofit institutions of higher education or at nonprofit organizations whose primary purpose is the conduct of scientific research, the contracting officer shall use the clause with its Alternate II.

52.245-2 - Government Property (Fixed-Price Contracts).

(c) Title in Government property.

- (1) The Government shall retain title to all Government-furnished property.
- (2) All Government-furnished property and all property acquired by the Contractor, title to which vests in the Government under this paragraph (collectively referred to as Government property), are subject to the provisions of this clause. However, special tooling accountable to this contract is subject to the provisions of the Special Tooling clause and is not subject to the provisions of this clause. Title to Government property shall not be affected by its incorporation into or attachment to any property not owned by the Government, nor shall lose its identity as personal property by being attached to any real property.
- (3) Title to each item of facilities and special test equipment acquired by the Contractor for the Government under this contract shall pass to and vest in the Government when its use in performing this contract commences or when the Government has paid for it, whichever is earlier, whether or not title previously vested in the Government.
- (4) If this contract contains a provision directing the Contractor to purchase material for which the Government will reimburse the Contractor as a direct item of cost under this contract -
 - (i) Title to material purchased from a vendor shall pass to and vest in the Government upon the vendor's delivery of such material; and
 - (ii) Title to all other material shall pass to and vest in the Government upon -
 - (A) Issuance of the material for use in contract performance;
 - (B) Commencement of processing of the material or its use in contract performance;
 - or
 - (C) Reimbursement of the cost of the material by the Government, whichever occurs first.

Alternate I. (Added April 1984)

(g) Limited risk of loss. (Not applicable to questions of title)

Alternate II. (Added July 1985)

(c) Title in Government property.

- (1) The Government shall retain title to all Government-furnished property.
- (2) All Government-furnished property and all property acquired by the Contractor, title to which vests in the Government under this paragraph (collectively referred to as Government property), are subject to the provisions of this clause. Title to Government property shall not be affected by its incorporation into or attachment to any property not owned by the Government, nor shall Government property become a fixture or lose its identity as personal property by being attached to any real property.
- (3) Title to each item of facilities, special test equipment, and special tooling (other than that subject to a special tooling clause) acquired by the Contractor for the Government under this contract shall pass to and vest in the Government when its use in performing this contract commences, or when the Government has paid for it, whichever is earlier, whether or not title previously vested in the Government.
- (4) Title to equipment (and other tangible personal property) purchased with funds available for research and having an acquisition cost of less than \$5,000 shall vest in the Contractor upon acquisition or as soon thereafter as feasible; provided, that the Contractor obtained the Contracting Officer's approval before each acquisition. Title to equipment purchased with funds available for research and having an acquisition cost of \$5,000 or more shall vest as set forth in the contract. If title to equipment vests in the Contractor under this subparagraph (c)(4), the Contractor agrees that no charge will be made to the Government for any depreciation, amortization, or use under any existing or future Government contract or subcontract thereunder. The Contractor shall furnish the Contracting Officer a list of all equipment to which title is vested in the Contractor under this subparagraph (c)(4) within 10 days following the end of the calendar quarter during which it was received.
- (5) Vesting title under this paragraph (c) is subject to civil rights legislation, 42 U.S.C. 2000d. Before title is vested and by signing this contract, the Contractor accepts and agrees that - No person in the United States shall, on the ground of race, color, or national origin, be excluded from participation in, be denied the benefits of, or be otherwise subjected to discrimination under this contemplated financial assistance (title to equipment).

FEDERAL ACQUISITION REGULATIONS (FAR'S) GOVERNMENT
PROPERTY (COST REIMBURSEMENT, TIME-AND-MATERIAL,
OR LABOR-HOUR CONTRACTS)

EXHIBIT 10D
Page 1 of 2

CODE OF FEDERAL REGULATIONS
TITLE 48
FEDERAL ACQUISITION REGULATIONS SYSTEM

52.245-5

Government Property

**(Cost-Reimbursement, Time-and-Material, or
Labor-Hour Contracts)**

(Formerly ASPR 7-203.21)

Effective April 1, 1984
Amended December 1986

The Contracting Officer shall insert 52.245-5 in solicitations and contracts when a cost-reimbursement, time-and-material, or labor-hour contract is contemplated, unless the acquisition cost of all Government-furnished property to be involved in the contract is \$50,000 or less (excluding contracts with educational or nonprofit organizations) in which case 52.254-4 (short form) may be used.

If the contract is for the conduct of basic or applied research at nonprofit institutions of higher education or at nonprofit organizations whose primary purpose is the conduct of scientific research, the contracting officer shall use the clause with its Alternate I.

52.245-5

(c) Title.

- (1) The Government shall retain title to all Government-furnished property.
- (2) Title to all property purchased by the Contractor for which the Contractor is entitled to be reimbursed as a direct item of cost under this contract shall pass to and vest in the Government upon the vendor's delivery of such property.
- (3) Title to all other property, the cost of which is reimbursable to the Contractor, shall pass to and vest in the Government upon -
 - (i) Issuance of the property for use in contract performance.
 - (ii) Commencement of processing of the property or use in contract performance;
or
 - (iii) Reimbursement of the cost of the property by the Government, whichever occurs first.
- (4) All Government-furnished property and all property acquired by the Contractor, title to which vests in the Government under this paragraph (collectively referred to as Government property), are subject to the provisions of this clause. Title to Government property shall not be affected by its incorporation into or attachment to any property not owned by the Government, nor shall Government property become a fixture or lose its identity as personal property by being attached to any real property.

Alternate I. (Added July 1985)

(c) Title.

- (1) The Government shall retain title to all Government-furnished property.
- (2) All Government-furnished property and all property acquired by the Contractor, title to which vests in the Government under this paragraph (collectively referred to as Government property), are subject to the provisions of this clause. Title to Government property shall not be affected by its incorporation into or attachment to any property not owned by the Government, nor shall Government property become a fixture or lose its identity as personal property by being attached to any real property.
- (3) Title to all property purchased by the Contractor for which the Contractor is entitled to be reimbursed as a direct item of cost under this contract and that, under the provisions of this contract is to vest in the Government, shall pass to and vest in the Government upon the vendor's delivery of such property. Title to all other property, the cost of which is to be reimbursed to the Contractor under this contract and that under the provisions of this contract is to vest in the Government, shall pass to and vest in the Government upon -
 - (i) Issuance of the property for use in contract performance;
 - (ii) Commencement of processing of the property or its use in contract performance;
or
 - (iii) Reimbursement of the cost of the property by the Government, whichever occurs first.
- (4) Title to equipment (and other tangible personal property) purchased with funds available for research and having an acquisition cost of less than \$5,000 shall vest in the Contractor upon acquisition or as soon thereafter as feasible; provided, that the Contractor obtained the Contracting Officer's approval before each acquisition. Title to equipment purchased with funds available for research and having an acquisition cost of \$5,000 or more shall vest as set forth in the contract. If title to equipment vests in the Contractor under this subparagraph (c)(4), the Contractor agrees that no charge will be made to the Government for any depreciation, amortization, or use under any existing or future Government contract or subcontract thereunder. The Contractor shall furnish the Contracting Officer a list of all equipment to which title is vested in the Contractor under this subparagraph (c)(4) within 10 days following the end of the calendar quarter during which it was received.
- (5) Vesting title under this paragraph (c) is subject to civil rights legislation, 42 U.S.C. 2000d. Before title is vested and by signing this contract, the Contractor accepts and agrees that -

No person in the United States shall, on the ground of race, color, or national origin, be excluded from participation in, be denied the benefits of, or be otherwise subjected to discrimination under this contemplated financial assistance (title to equipment).

CODE OF FEDERAL REGULATIONS
TITLE 48
FEDERAL ACQUISITION REGULATIONS SYSTEM

52.245-17

Special Tooling

(Formerly ASPR 7-104.25)

Effective April 1, 1984

Amended December 1989

The contracting officer shall insert 52.245-17 in solicitations and contracts when a fixed-price contract is contemplated, and either the contract will include special tooling provided by the Government or the Government will acquire title or right to title in special tooling to be acquired or fabricated by the contractor for the Government, other than special tooling to be delivered as an end item under the contract. The Special Tooling clause shall apply to all special tooling accountable to the contract.

54.245-17

(a) Definition.

Special tooling means jigs, dies, fixtures, molds, patterns, taps, gauges, other equipment and manufacturing aids, all components of these items, and replacements of these items that are of such a specialized nature that without substantial modification or alteration their use is limited to the development or production of particular supplies or parts thereof or performing particular services. It does not include material, special test equipment, facilities (except foundations and similar improvements necessary for installing special tooling), general or special machine tools, or similar capital items. Special tooling for the purpose of this clause, includes all special tooling acquired or fabricated by the Contractor for the Government (other than special tooling to be delivered as a line item) or furnished by the Government for use in connection with and under the terms of the contract.

(b) Title.

The Government retains title to Government-owned special tooling and option to take title to all special tooling subject to this clause until such time as title or option to take title is relinquished by the Contracting Officer as provided for in subparagraphs (j)(2) and (j)(3) of this clause.

(j) Disposition instructions.

- (1) The Contracting Officer may identify specific items of special tooling to be retained or give the Contractor a list specifying the products, parts, or services including follow-on requirements for which the Government may require special tooling and request the Contractor to identify all usable items of special tooling on hand that were designed for or used in the production or performance of such products, parts, or services. Once items of usable special tooling required by the Government are identified, the Contracting Officer may -
 - (i) Direct the Contractor to transfer specified items of special tooling to follow-on contracts requiring their use. Those items shall be furnished for use on the contract(s) as specified by the Contracting Officer and shall be subject to the provisions of the gaining contract(s); or
 - (ii) Request the Contractor to enter into an appropriate storage contract for special tooling specified to be retained by the Contractor for the Government. Tooling to be stored shall be stored pursuant to a storage contract between the Government and the Contractor; or
 - (iii) Direct the Contractor to transfer title to the Government (to the extent not previously transferred) and deliver to the Government those items of special tooling which are specified for removal from the Contractor's plant.
- (2) The Contracting Officer may direct the Contractor to sell, or dispose of as scrap, for the account of the Government, any special tooling not specified by the Government pursuant to subparagraph (j)(1) of this clause. To the extent that the Contractor incurs any costs occasioned by compliance with such direction, for which it is not otherwise compensated, the contract price shall be equitably adjusted in accordance with the Changes clause of this contract. The net proceeds of all sales shall either be credited to the cost of contract performance or shall be otherwise paid to the Government as directed by the Contracting Officer. Sale of special tooling to the prime Contractor or any of its subcontractors is subject to the prior written approval of the Contracting Officer.
- (3) The Contracting Officer may furnish the Contractor with a statement disclaiming further Government interest or right in specified special tooling.

FEDERAL ACQUISITION REGULATIONS (FAR'S)
SPECIAL TEST EQUIPMENT

EXHIBIT 10F

CODE OF FEDERAL REGULATIONS
TITLE 48
FEDERAL ACQUISITION REGULATIONS SYSTEM
52.245-18
Special Test Equipment
(Formerly ASPR 7-104.26)

Effective April 1, 1984

Amended August 1988

The contract officer shall insert 52.245-18 in solicitations and contracts when contracting by negotiation and the contractor will acquire or fabricate special test equipment for the Government but the exact identification of the special test equipment to be acquired or fabricated is unknown.

52.245-18

- (a) Special test equipment, as used in this clause, means either single or multipurpose integrated test units engineered, designed, fabricated, or modified to accomplish special purpose testing in performing a contract. It consists of items or assemblies of equipment, including standard or general purpose items or components, that are interconnected and interdependent so as to become a new functional entity for special testing purposes. It does not include material, special tooling, facilities (except foundations and similar improvements necessary for installing special test equipment), and plant equipment items used for general plant testing purposes.

General Retailers	
Step	Task
1	Locate all books and records available for audit.
2	Get a description of the product sold. Visit the store if the audit is not performed on-site.
3	Find out who prepared the returns during the audit period. Have them show you the source(s) of their figures
4	Run AUD TR to obtain a transcript of returns (414-M). Close to when you turn in the audit run it again to verify that no adjustments have been made that affect your audit results.
5	Review the sales tax return worksheets for accuracy, consistency, and method of reporting.
6	Reconcile reported sales per 414-M to books, FITRs, and financial statements.
7	Perform a sales tax accrual analysis.
8	Verify sales detail. Spot test sales invoices/Z-tapes to sales journal. Compare sales journal to general ledger on an actual basis.
	Compute book markups by year.
9	<ul style="list-style-type: none"> a. Determine if markups are acceptable. b. If not acceptable, conduct a markup test.
	Verify the accuracy of claimed deductions:
10	<ul style="list-style-type: none"> a. Sales for resale - Resale certificates, qualifying purchase orders, auditor judgment. b. Labor - Watch for fabrication/assembly labor, services in connection with the sale of tangible personal property. c. Government - Federal government only. Check for purchase orders. d. Interstate Commerce - Bills of lading, shipping documents. e. Bad Debts - Taxable sales only. f. Freight - Separately stated freight out, no handling fee.
	Check for potential use tax liability (usually minimal):
11	<ul style="list-style-type: none"> a. Fixed assets b. Consumable supplies c. Withdrawals from inventory

NOTE: These audit programs are general in nature, and will not cover all potential situations that could be encountered. They should only be used as a starting point for a customized audit program for each taxpayer

Manufacturers and/or Wholesalers

Step	Task
1	Locate all books and records available for audit.
2	Get a description of the product sold. Visit the store if the audit is not performed on-site.
3	Find out who prepared the returns during the audit period. Have them show you the source(s) of their figures
4	Run AUD TR to obtain a transcript of returns (414-M). Close to when you turn in the audit run it again to verify that no adjustments have been made that affect your audit results.
5	Review the sales tax return worksheets for accuracy, consistency, and method of reporting.
6	Reconcile reported sales per 414-M to books, FITRs, and financial statements.
7	Look for miscellaneous sales - sales of assets, sales to employees, etc.
8	Sales tax accrual analysis.
	Verify the accuracy of claimed deductions:
9	a. Sales for resale - Resale certificates, qualifying purchase orders, auditor judgment.
	b. Labor - Watch for fabrication/assembly labor, engineering charges, services in connection with the sale of tangible personal property.
	c. Government - Federal government only. Check for purchase orders.
	d. Interstate Commerce - Bills of lading, shipping documents.
	e. Freight - Separately stated freight out, no handling fee.
	Verify the accuracy of claimed deductions:
10	a. Fixed assets
	b. Consumable supplies
	c. Research and development
	d. Manufacturing aids
	e. Withdrawals from inventory
	f. Sample

Liquor Stores

Step	Task
1	Locate all books and records available for audit.
2	Find out who prepared the returns during the audit period. Have them show you the source(s) of their figures.
3	Run AUD TR to obtain a transcript of returns (414-M). Close to when you turn in the audit run it again to verify that no adjustments have been made that affect your audit results.
4	Review sales tax return worksheets to verify accuracy, consistency and method of reporting.
5	Reconcile sales:
	a. Reported sales per 414-M to books, FITRs, and Profit & Loss Statements (P & L).
	b. Recorded sales per the P & L to the FITRs.
	c. Taxable and nontaxable sales per P & L to reported/claimed amounts. Note: Analyze deli sales and purchases separate from liquor store sales and purchases.
6	Analyze the FITRs for overall markup.
7	Verify sales correctly posted to P & L. Trace from register tape to sales journal to general ledger to P & L.
8	Verify purchases correctly segregated and posted (taxable vs. nontaxable). Trace from purchase invoices to cash disbursements journal to P & Ls.
9	Calculate markup for taxable and nontaxable sales.
10	If all of the above is acceptable, with no reconciliation, segregation, or posting errors, and markups are reasonable, write up the audit. Note: Markups vary depending on location and type of business.
11	If the markups are reasonable, but a material reconciliation difference exists between taxable sales recorded and reported, schedule the differences and assess in the audit.
12	If purchases need to be segregated, segregate them into the same categories as sales and recalculate markups.
13	If the markups are unacceptable, do a shelf-test
	a. If both the overall and taxable markups are low and there are no posting entry errors noted, impeach total sales and do a taxable shelf-test. Markup taxable purchases (adjusted for pilferage and self-consumption)
	b. If the overall markup is acceptable and there are no posting errors noted, but the taxable markup is low, accept total sales as reported and do a shelf-test on nontaxable items (food). Compute audited food sales using the shelf-test markup and compare to claimed exempt amounts. Disallow over-claimed amounts. Note: This type of situation indicates a key-ring error. This type of audit is done on a total sales basis and makes the taxpayer support his/her claimed deduction.
	c. If both the overall and nontaxable markups are low and there are no posting errors noted, but the taxable markup is reasonable, accept reported/claimed figures. The overall markup is pulled down due to nontaxable sales.

Liquor Stores

Step	Task
14	Miscellaneous items
a.	When computing audited sales using a shelf-test markup, be sure to adjust purchases for inventory fluctuations, segregation errors, actual theft of inventory (supported by documentation), self-consumed, and 1% pilferage. Watch for climbing inventories.
b.	Watch self-consumption of taxable items. Include unreported items at cost in audit findings. Amounts can be estimated, but make sure they are reasonable. Claimed self-consumed items should be itemized by category (soda, liquor, beer, wine, cigarettes, cleaning and paper supplies) and analyzed in the working papers, to determine if amounts appear reasonable.
c.	Remove non-merchandise sales (lottery sales, money orders, check cashing, etc.) prior to markup calculation.
d.	Shelf-tests should compare current costs with current selling prices. Make sure if CRV is included in cost, it is also included in selling price and vice versa. Comment as to whether CRV is or is not included in the markup computation.
e.	Note any changes in the type of business during the audit period (for example, added deli).
f.	Based on internal controls (or lack of), a bank reconciliation may be necessary.
g.	Are there material amounts of unclaimed bad debts/checks? Write-off only allowed on taxable portion.
h.	Check sales and purchases of assets and consumable supplies (usually minor).
i.	Verify cigarette indicia.
j.	Verify cigarette rebates are properly reported.

FORM BOE-837 — AFFIDAVIT FOR SECTION 6388 OR 6388.5 EXEMPTION

BOE-837 (FRONT) REV. 3 (4-03)

AFFIDAVIT FOR SECTION 6388 OR 6388.5 EXEMPTION FROM CALIFORNIA SALES AND USE TAX

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

Revenue and Taxation Code (RTC) sections 6388 and 6388.5 provide exemptions from the taxes imposed on the sale, storage, use, or other consumption of certain new and remanufactured vehicles and trailers. The RTC section 6388 exemption applies to the sale or use of certain new or remanufactured vehicles. The RTC section 6388.5 exemption applies to the sale or use of certain new or remanufactured trailers. Additional information about these exemptions and additional requirements to meet these exemptions is available on the back of this form and in Regulation 1620.1, *Sales of Certain Vehicles and Trailers for Use in Interstate or Out-Of-State Commerce*.

CHECK AND/OR FILL IN ALL APPROPRIATE BOXES AND BLANKS BELOW

I have purchased a vehicle or trailer the sale and use of which is exempt from California sales and use tax per section 6388 6388.5.

Vehicle or Trailer Information:

The vehicle is a truck, truck tractor, trailer, semitrailer, trailer coach, or auxiliary dolly, described as:

MAKE & MODEL	VIN/SERIAL NO.	YEAR	PURCHASE PRICE	UNLADEN WEIGHT
MANUFACTURER/REMANUFACTURER		PLACE OF MANUFACTURE/REMANUFACTURE		DATE OF DELIVERY

The vehicle or trailer was moved outside California within 30 75 days of delivery (check one). Date moved: _____

Seller and Deliverer of Vehicle or Trailer:

I hereby certify that the vehicle or trailer described above was purchased from _____
(name of dealer or mfr./remfr.)

located at _____, and was delivered by _____
(dealer or mfr./remfr.'s address - street, city, state, zip code)

_____, located at _____
(name of California dealer or mfr./remfr.) (California dealer or mfr./remfr.'s address - street, city, state, zip code)

Leasing and Registration Information:

The vehicle or trailer described above is is not being leased. If being leased, name and address of lessee:

Vehicle or trailer is licensed or registered in _____
(state where registered) (If a trailer is registered in California, provide owner's or lessee's USDOT number or FMC number)

Purchaser Information:

The purchaser is a corporation limited liability company partnership sole proprietor, which is is not a resident of California. The vehicle was purchased for use outside California (section 6388) or the trailer was purchased for use exclusively outside California or exclusively in interstate and foreign commerce, or both (section 6388.5). **If the trailer or vehicle is registered outside California, a copy of the purchaser's or lessor's out-of-state registration, or license and registration, will be provided within 60 days from the date of this affidavit. If the trailer is registered in California under the PTI program, a copy of the purchaser's or lessee's USDOT number, FMC number, or current SSRS filing is attached.**

I understand that if I do not meet the requisite exemption provisions detailed on the back of this form, I am required by the California Sales and Use Tax Law to report and pay tax, and interest and penalties (if appropriate), directly to the California State Board of Equalization, the tax to be measured by the purchase price of the above listed vehicle or trailer even though I have furnished an affidavit of exemption to the manufacturer, remanufacturer, or dealer.

PURCHASER'S NAME

SIGNATURE OF PURCHASER OR PURCHASER'S AGENT	TITLE	
	PHONE NUMBER	DATE
PRINT NAME OF SIGNATOR	()	

For exemption requirements and instructions on completing this affidavit, please see back of form.

CLEAR PRINT

FORM BOE-526 — MANAGED AUDIT PROGRAM PARTICIPATION AGREEMENT

BOE-526 (S1F) REV. 2 (2-04)

MANAGED AUDIT PROGRAM PARTICIPATION AGREEMENT

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

NAME	ACCOUNT
------	---------

This is a Managed Audit Program (MAP) Participation Agreement between the California State Board of Equalization (Board) and _____ (taxpayer)

TAXPAYER'S NAME

in accordance with sections 7076.1 through 7076.5 of the California Revenue and Taxation Code. (All subsequent references to section numbers refer to the California Revenue and Taxation Code.)

remove along perforation

1. For the managed audit to be conducted under the MAP for the period beginning on _____ and ending on _____, the taxpayer represents that
 - The taxpayer's business involves few or no statutory exemptions and a single or a small number of clearly-defined taxability issues, and
 - The taxpayer agrees to participate in the MAP and has the resources to comply with the managed audit instructions provided by the Board.
2. The taxpayer shall complete the managed audit on or before _____ in accordance with the instructions in this agreement. The taxpayer shall make available to the Board by this date all computations, all transaction worksheets (as described in paragraph 3 below), and all books, records, and equipment relating to the managed audit for verification by the Board.
3. The types of transactions covered by this managed audit are listed in Section 1 of the Appendix of this agreement. In performing the managed audit, the taxpayer shall
 - Review and separately maintain for verification by the Board the books, records, and equipment specifically identified by the Board in Section 2 of the Appendix,
 - Follow the specific procedures listed in Section 2 of the Appendix to determine the amount of the unreported tax liability, if any,
 - Schedule the transactions relating to each of the books, records, and equipment identified in Section 2 of the Appendix by completing transaction worksheets provided by the Board, in accordance with the instructions in Board publication 53, *Guide to the Managed Audit Program*, a copy of which has been given to the taxpayer, and
 - Follow the special instructions (criteria), if any, described in Section 3 of the Appendix.
4. When the taxpayer has completed the managed audit, the Board may verify the results of the managed audit by reviewing the documents prepared by the taxpayer, by examining the books, records, and equipment of the taxpayer, and by taking any other necessary actions to verify the results of the managed audit, including requesting further information and documentation from the taxpayer.
5. If the Board determines that certain types of transactions should be audited by the Board and not by the taxpayer under the MAP, the Board shall notify the taxpayer either during or after the managed audit which types of transactions will be reviewed by the Board and what books, records, and equipment the Board must examine. If the Board determines that an unreported tax liability exists for those types of transactions which the Board audits pursuant to this paragraph, the interest rate set forth in paragraph 7 shall apply with respect to that liability unless the Board voids this agreement pursuant to paragraph 10.
6. Upon completion of the managed audit by the taxpayer, the verification of the managed audit by the Board, and the audit by the Board of transactions not audited under the MAP, the liability, if any, may be determined and collected by the Board and petitioned by the taxpayer in the manner provided in chapter 5 (commencing with section 6451) and chapter 6 (commencing with section 6710) of Revenue and Taxation Code part 1, division 2. As provided by section 6565, all determinations made by the Board under these

Current as of February 2004

BOE-526 (S1B) REV. 2 (2-04)

provisions of the Revenue and Taxation Code are due and payable at the time they become final. If they are not paid when due and payable, the Board shall add to them a penalty of 10 percent of the amount of the determination, not including interest and penalties.

7. Upon completion of the managed audit and verification by the Board, interest shall be computed at one-half the rate that would otherwise be imposed for liabilities covered by the audit period, in accordance with section 7076.4. This reduced interest rate shall remain in effect until the tax liability is paid in full unless the Board voids this agreement as provided in paragraph 10.
8. As provided in section 7076.2, subdivision (b), the information provided by the taxpayer shall be the same information required for the completion of any other audit that the Board may conduct.
9. Nothing in this agreement shall limit the Board's authority, under section 7054, to examine the taxpayers' books, records, and equipment. Nothing in this agreement shall limit the authority of the Board to determine an unreported tax liability or a refund or credit greater than or less than the unreported tax liability or refund or credit computed by the taxpayer in the managed audit.
10. The Board may void this agreement if the Board determines that
 - The taxpayer has failed to complete the managed audit by _____ in accordance with the provisions in this agreement, DATE
 - The taxpayer has refused to cooperate with the Board during the verification process described in paragraph 4 above or has refused to cooperate with the Board if the Board audits any transactions as provided in paragraph 5 above,
 - Any of the penalties under sections 6484, 6485, 6485.1, 6514, or 6514.1 should be imposed during the audit period,
 - There is jeopardy of collection under section 6536, or
 - The taxpayer has not paid the tax, interest, and penalties resulting from the managed audit (1) within 30 days of the issuance date of the related *Notice of Determination* or (2) as agreed upon in a formal installment payment agreement.

If the Board determines that this agreement should be voided, the Board shall notify the taxpayer in writing. If the Board voids this agreement, interest shall be computed at the full rate as provided in section 6591.5. In addition, the Board may proceed to examine the taxpayer's books, papers, records, and equipment in a manner to be determined by the Board, and any liability may be determined and collected by the Board and petitioned by the taxpayer in the manner provided in chapter 5 (commencing with section 6451) and chapter 6 (commencing with section 6701) of the Revenue and Taxation Code.

11. The Board has given the *Guide to the Managed Audit Program* to the taxpayer for instructional purposes. If there is a conflict between that publication and the Sales and Use Tax Law or this agreement, the Sales and Use Tax Law and this agreement shall control.

SIGNATURE <i>(name of taxpayer)</i>	DATE
NAME/TITLE <i>(print full name and title)</i>	
SIGNATURE <i>(Board of Equalization District Principal Auditor)</i>	DATE
NAME/TITLE <i>(print full name and title)</i>	

Current as of February 2004

BOE-526 (S2F) (2-04)

APPENDIX
Managed Audit Program Participation Agreement

NAME		ACCOUNT NUMBER
AUDIT PERIOD	From	To

SECTION 1

The types of transactions to be audited by the taxpayer are checked below:

- | | |
|---|--|
| <input type="checkbox"/> Sales for Resale | <input type="checkbox"/> Installation Labor |
| <input type="checkbox"/> Sales of Property Shipped Outside California | <input type="checkbox"/> Repair Labor |
| <input type="checkbox"/> Shipping and Delivery Charges | <input type="checkbox"/> Cash Discounts |
| <input type="checkbox"/> Sales to the United States Government | <input type="checkbox"/> Property Purchased For Resale |
| <input type="checkbox"/> Purchases from Out-of-State Vendors | |
| <input type="checkbox"/> Other: _____ | |

SECTION 2

The books, records, and equipment that are to be reviewed by the taxpayer are checked below:

- | | |
|--|---|
| <input type="checkbox"/> Sales Invoices | <input type="checkbox"/> Freight Bills |
| <input type="checkbox"/> Sales Contracts | <input type="checkbox"/> Other Shipping or Delivery Documentation |
| <input type="checkbox"/> Resale Certificates | <input type="checkbox"/> Purchase Orders |
| <input type="checkbox"/> Bills of Lading | <input type="checkbox"/> Purchase Invoices |
| <input type="checkbox"/> Other: _____ | |

The procedures to determine the amount of any unreported tax liability are described on pages 4 through 11 of the *Guide to the Managed Audit Program*. The taxpayer will be reviewing the books, records, and equipment checked above for the following periods:

TEST PERIODS

_____	_____	_____
_____	_____	_____

Description of method for review: _____

SECTION 3

Special Instructions (Criteria):

- None
- Other: _____

continues on reverse

Current as of February 2004

GENERAL AUDIT PROCEDURES

FORM BOE-52 — CERTIFICATE OF VERIFICATION
OUT OF STATE DELIVERY

EXHIBIT 14

BOE-52 (11-99)
CERTIFICATE OF VERIFICATION
OUT-OF-STATE DELIVERY

STATE OF CALIFORNIA
BOARD OF EQUALIZATION



Please complete this inquiry statement to indicate the disposition of certain non-taxed purchases you made in this state from the seller listed below:

NAME OF SELLER	PERMIT NUMBER
----------------	---------------

STREET ADDRESS (city, state, zip code)

NAME OF PURCHASER

STREET ADDRESS (city, state, zip code)

DESCRIPTION OF TANGIBLE PERSONAL PROPERTY

INVOICE NUMBER	DATE OF INVOICE
----------------	-----------------

ITEM(S) (description)

TOTAL SALES PRICE

\$

PURCHASER'S DECLARATION

The undersigned purchaser, or authorized representative thereof, declares that the property described above was delivered directly to the purchaser outside California at the place and on the date indicated below. If you did not purchase the item(s) or have the item(s) listed above shipped to you, or if you took delivery in California, please mark the applicable box below and complete the comments section.

PLACE OF OUT-OF-STATE DELIVERY (city and state)	DATE
---	------

Did not purchase or take delivery Took delivery in California (location and date)

LOCATION	DATE
----------	------

SIGNATURE OF PURCHASER OR AUTHORIZED REPRESENTATIVE

PRINT NAME OF PURCHASER OR AUTHORIZED REPRESENTATIVE	TELEPHONE ()
--	-----------------------

COMMENTS

This form is to be completed in triplicate. ORIGINAL AND SECOND COPY TO BE RETURNED TO THE BOARD. THIRD COPY IS FOR SELLER'S RECORDS.

FORM BOE-52-L — SAMPLE LETTER,
SELLER RECEIPT OF GOODS IN INTERSTATE COMMERCE

EXHIBIT 14A

BOE-52-L REV. 1 (3-00)

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

SAMPLE LETTER FOR SELLER
Requesting Purchaser's Statement
Regarding Receipt of Goods in Interstate Commerce

Purchaser's Name
Address
City, State, Zip

Salutation:

Auditors of the California State Board of Equalization are currently examining [**Business Name**] records to verify that untaxed sales made to you were properly claimed as exempt sales in interstate commerce under the California Sales and Use Tax Law. Specifically, they would like to 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, please 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.

Please 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 our claims for exemption. Thank you for your cooperation.

Sincerely,

Name
Title

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



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

**FORM BOE-52-L2 — SAMPLE LETTER FOR SELLER NOTICE
OF PENDING REFUND OF EXCESS SALES TAX REIMBURSEMENT**

EXHIBIT 14C

BOE-52-L2 (8-03)

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

Sample Letter for Seller
Notice of Pending Refund of Excess Sales Tax Reimbursement

[Customer Name]
[Address]
[City, State, Zip Code]

[Date]

Dear [Customer],

A review of our sales records disclosed that we erroneously collected excess tax reimbursement from you in the amount of [] for the period [xx-xx-xx] to [yy-yy-yy]. Excess tax reimbursement occurs when the sales tax reimbursement is overstated due to a mathematical or clerical error or when reimbursement is computed on a transaction, which is not subject to tax or on an amount in excess of the amount subject to tax. Excess tax reimbursement also occurs when a retailer uses a tax rate higher than the rate imposed by law.

We have filed a claim for refund with the State Board of Equalization for the excess tax collected. Once we receive a refund from the Board, we will refund the money to you. Please indicate if you would like the amount sent to you or credited to your account.

send the refund to me credit my account

Please acknowledge receipt of this notice by completing the information below, and returning it to our office promptly. Keep a copy of this form for your files. In accordance with Sales and Use Tax Regulation 1700, the Board of Equalization will not issue a refund for this tax to us until we have your signed acknowledgement that we are obligated to return the overpayment of sales tax to you.

The validity of all refund claims is subject to review and approval by the Board of Equalization.

COMPANY NAME	
BY (print name)	
SIGNATURE	TITLE
DATE	TELEPHONE ()

Sincerely,

[Name]
[Title]

**SAMPLE MEMO, REPORT OF SUSPECTED
MONEY LAUNDERING ACTIVITY**

EXHIBIT 15

State of California

Board of Equalization

M e m o r a n d u m

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>.