

OUR SECRETS FOR A CALIFORNIA SALES TAX AUDIT DEFENSE



BROTMAN LAW



INTRODUCTION

If you are a small business owner in California selling tangible personal property, you should be collecting and reporting sales tax. You also have to file sales tax returns with the state of California.

In our experience, most small businesses try to do things correctly when it comes to their sales and use tax compliance. The last thing that pretty much every company wants is to run afoul with the California Department of Tax and Fee Administration.

However, sales tax is an area of the law that is confusing to many people, including tax attorneys that do not focus on state taxation. Even for people that try and stay compliant with the sales tax laws, your business can still be a target for the CDTFA and be hit with a California sales tax audit.

That is why our law firm has dedicated the time and the resources to creating our complete guide to California sales tax audits. We wanted to put together the best resource on the internet for taxpayers faced with the prospect of a CDTFA audit. The state government publishes little guidance to help those facing audit and there is a lot of misinformation out there.

We have also noticed that when speaking to businesses and business owners that many people do not really understand the audit process. So, we decided to tackle this issue head on and to reveal many of the tips, tactics, and strategies that we use in our law firm for dealing with sales tax problems.

Although our ultimate guide is fairly daunting and some of the material is rather technical, it is not our intention that you sit down and read this cover to cover. Rather, we have broken

everything down into a smaller, easy to digest chapters that cover different aspects of the sales tax audit process and to give you a better understanding of what the law is and how to deal with your tax auditor.

As always, our tax law firm is about trying to help people and we are always here if you have questions or need further assistance. One of the reasons that we publish these resources is to help not only our clients, but anyone who stumbles upon our website and is in need of a helping hand.

Regardless of whether or not you have the means to retain a California sales tax audit lawyer to help you with your CDTFA audit, we want you to not be on an unequal playing field with the auditor, so we have written down and shared some of our best sales tax audit defense tactics and sales tax audit strategies to help you.

Thank you in advance for reading “A Tax Attorney’s Complete California Sales Tax Audit Guide.” It was a labor of love and our law firm welcomes all questions, comments, concerns, and feedback that you may have about this free resource.



SALES TAX AUDITS: WHAT YOU NEED TO KNOW

A sales tax audit is exactly what it sounds like; the California Department of Tax and Fee Administration (CDTFA) comes in and checks to make sure that sales tax was paid properly. The goal of an audit is to find misreported or unpaid taxes which have been neglected either in error or through tax evasion.

Exactly how an audit is conducted varies depending on the type of business being audited, but at a minimum, it includes an examination of records such as sales and use tax returns and worksheets, state and federal income tax returns, ledgers, invoices, statements, till receipts and more.

What does the sales tax audit process look like? Sales tax audits are pretty rough. They involve large amounts of data, complicated statistical methods and in certain cases, they involve sampling.

This means that the state can go through a business's records over three years and audit every single transaction, but the problem with a lot of businesses, particularly a lot of retail businesses, is cash transactions.

The auditor and the representative are working through this very large amount of data and trying to make conclusions on it to make sure the appropriate amount of tax was paid in statement.

For some businesses, you can have tens of

thousands, if not, hundreds of thousands, even millions of transactions over a three-year period. We see businesses all the time, particularly those with low margins and high frequency, that just have an absolutely insane amount of transactions.

In some cases, tax auditors may use other types of tests such as markup analysis, statistical sampling, credit card percentage tests, and even undercover operations such as "pour tests" in bars and restaurants.

A sales tax audit can happen for any reason; sometimes it is just your turn to be audited. However, there are many circumstances which may make it more likely that you will be selected.

If your business is largely cash-based, if you work in an industry known for high rates of non-compliance, if one of your vendors has been audited or if you have had tax problems in the past, you may be at greater risk of a sales tax audit. If you have recently gone out of business, you can still be audited, and the CDTFA will attempt to hold you and anyone else directly involved personally responsible for found liabilities.

Most California businesses will deal with a sales tax audit at some point, and understanding why and when sales tax audits happen and what to expect is the best way to be prepared when your number comes up.

Our firm, Brotman Law, has seen firsthand



how painstaking and drawn-out the sales tax audit process is, because there are so many variables, tests and even opinions involved. We are a small business and we specialize in working with small businesses in all tax matters, including sales tax audits.

Keep reading as we walk you through the California Department of Tax and Fee Administration (CDFTA) sales tax audit

process, how to prepare, how to present your documents, risks, problems, strategies, whether you should settle or appeal and how you would benefit from legal representation.

The following is an overview and summary of each of the different chapters in “A Tax Attorney’s Complete California Sales Tax Audit Guide.”

CHAPTER SUMMARIES

01 What Is California Sales Tax?

In this chapter, we define both sales and use taxes and we discuss the mechanics for how sales taxes work in California.

We discuss how the sales tax permitting process works and the responsibilities for businesses that are issued a California seller’s permit by the California Department of Tax and Fee Administration, which is the body responsible for the administration and enforcement of sales and use tax laws in California.

Then, we look at the concept of “tangible personal property” and what type of sales are subject to California sales tax.

Finally, we discuss the government functions, roles, and responsibilities of the California Department of Tax and Fee Administration known as CDFTA.

02 What Triggers a Sales Tax Audit in California?

This chapter examines the process for how businesses are selected for a CDFTA audit and the general goals of the CDFTA in promoting tax compliance among sellers of tangible personal property in California.

We look at how businesses are targeted for sales tax audits and the common things that we have discovered in our tax law practice that trigger a California sales tax audit.

Then, we turn to how far back a sales tax audit can go and examine a few different things related to California’s statute of limitations for sales tax audits.

Finally, we take a deep dive into the role of the sales tax auditor, what they are looking for in a sales tax audit, and how they find sales tax mistakes during the course of their examination.



03 Risks For Your Small Business in a California Department of Tax and Fee Administration Audit

This next section is all about making sure that you understand and are prepared for the risks that a California sales tax audit poses to both your business and the owner personally.

As we will cover, the main problem with sales tax audits as opposed to a federal income tax audit (for example) is the amount of data you and the tax auditor have to deal with.

We talk briefly about statistical sampling (covered in detail in later chapters) and about civil and criminal penalties for sales tax fraud and serious errors on your business's sales tax returns.

Finally, we spend a little time discussing what a dual determination is in the context of an audit and how the tax auditor's decision to extend liability to business ownership can have pretty severe consequences.

04 The California Sales Tax Audit Process

Over the next several chapters, we will walk you through a California sales tax audit from start to finish and reveal insider information about how our firm handles audits.

As we explain, audits are won or lost well before the initial meeting with the auditor.

Sales tax audits are almost an exercise in planning over anything else. We will discuss what to you when you receive the initial audit notice and the document request attached.

Afterward, we talk about the initial contact with the auditor and the importance of having input into and pushing back on the tax auditor's plan for the audit.

We provide you with our tax attorney's recommended strategies for dealing with the CDTFA auditor and responding to the records request.

05 How to Prepare for Your California Sales Tax Audit

This chapter is about one thing: preparation, preparation, preparation. We will share some of the biggest mistakes that we have seen small businesses make during the audit process and how to prepare for the challenges that lie ahead in your first meeting with the sales tax auditor.

We look at common problems in the sales tax audit preparation process, how to deal with challenges associated with poor recordkeeping, gathering the documentation for your audit, and the importance of the integrity of data in the course of a sales tax audit.



Finally, we discuss the importance of eliminating confusion around what the sales and use tax law is and how to take advantage of the auditor's knowledge gaps.

06 How To File a California Sales Tax Audit Appeal

This chapter is all about the California sales tax appeals process for audits and CDTFA administrative tax resolutions.

We walk through both the receipt of the "Notice of Determination" and the response, which is called a "Petition for Redetermination."

The appeals process in California is a fairly informal proceeding, but it is marked by tight deadlines and you need to make sure that you are properly prepared going into the CDTFA appeals conference.

If not, there could be several adverse consequences of what happens when the audit goes wrong.

07 Should I Hire a California Sales Tax Lawyer to Help Me With My Sales Tax Audit?

Usually our firm are big proponents of clients educating and trying to resolve tax issues on their own accord, but we do not recommend going it alone (or with a CPA).

Hiring a California sales tax attorney and having the support of someone who is specifically knowledgeable about sales

and use tax law in California often make the difference in a tax audit.

You will see some of the strategies that we recommend and utilize in our California sales tax audit defense practice.

By providing this overview, we hope that you can get a sense of how you can take a process that seems like you are at a disadvantage and give you an advantage over the auditor.

08 How the California Sales Tax Audit Defense Practice Works with Brotman Law

This chapter contains a quick overview of what it is like to work with our firm.

We are one of the very few California tax law firms that focuses on our California sales tax audit defense practice and leverage our knowledge and working relationships with the local CDTFA district offices to our advantage in a sales tax audit and for the benefit of our clients.

Finally, we discuss the legal costs associated with retaining counsel in a sales tax audit. Usually, the cost/benefit associated with retaining counsel in a sales tax audit often makes this an easy choice.

Clients are often frustrated and stressed out by the audit process, but a sales tax attorney can help come in and get your California sales tax audit organized from start to finish.



09 What is Use Tax in California?

This is all about California use tax and California use tax audits. Use tax is often considered a companion tax to sales tax because use tax will often apply to situation where sales tax does not apply or where an exemption exists.

We cover a few more of the more technical issues associated with use tax in California and look at the impact of certain situations, such as resale certificates, on your sales tax audit. Sales tax issues and use tax issues often go hand and hand together.

10 Your Rights as a California Taxpayer

When you deal with the tax agencies of California, you may feel like you do not have any rights.

These agencies can be aggressive and overwhelming to most individuals not used to dealing with them.

However, you do have rights, an important detail to remember any time the CDFA contacts you.

In this chapter I give an overview of your rights as a taxpayer engaging with the California Department of Tax and Fee Administration.

11 What is Sampling and Testing in a Sales Tax Audit?

This chapter contains the most difficult, technical concepts that we have discussed in this guide, but they are at the core of some of the most important information.

Because sales tax often relies on statistical sampling, disputes in sales tax often come down to statistical matters even over the interpretation of the law.

In this chapter, we detail some of the methods that California tax auditors use when compiling data and how to challenge each method. You'll learn what to look out for when being audited and minimize your exposure.

12 Types of Testing Used in Sales Tax Audits

When it comes to sales tax audits, the CDTFA has established in its capacity that time is money, which is why its auditors will use short tests and sampling to abbreviate the process.

There are a variety of testing methods, which I will describe in this chapter. In a nutshell, the auditor is going to take a "snapshot" of your business' transactions, then extrapolate that to ultimately determine if you are copacetic with your sales tax reporting.

With careful planning, you can devise a strategy to control the audit and reduce the number of transactions that the auditor can look back at.



13 California Sales for Resale and Resale Audits

In this chapter, you can read about the two ways that a CDFA auditor will verify sales for resale and how an auditor will develop perimeters for their test, such as a time period and a method for screening data.

We also run through California sales tax audits for sales for resale three classification categories:

- Detailed audit — lists of claimed sales for resale available
- Detailed audit — lists of claimed sales for resale not available
- Audit on test basis

14 Sales Tax Requirements for Retailers Outside of California

An out-of-state retailer “engaged in business in California is required to register, collect use tax on taxable sales made to consumers in California, and remit this tax to the California Department of Tax and Fee Administration.

This encompasses a wide scope of descriptions, including maintaining office space. If you do any sort of retail business or have an agent doing business for you, this chapter will provide you with some important information.

15 What Types of Penalties Can I Face in a California Sales Tax Audit?

The next chapters deal with penalties that are commonly associated with sales tax audits and how to mitigate and deal with those penalties in the context of the audit.

Often, we tell our clients to be equally mindful of the penalty portion of their potential liabilities in an audit and we do whatever we can during the audit in order to mitigate those sales tax penalties.

16 Negligence Penalties in California Sales Tax Audits

The CDTFA recognizes two major classes of negligence: negligence in keeping records and negligence in preparing returns.

These two types of negligence allow for the imposition of the negligence penalty. In this chapter I will discuss Negligence Penalties, which are defined in general as a failure to exercise due (proper) care that a reasonable and prudent person would exercise under similar circumstances.

In addition, with respect to business tax matters, negligence may be further defined as a substantial breach by the taxpayer of some duty imposed by the law.



17 What Are the Penalties for Tax Evasion and Tax Faud in California Sales Tax Audits?

Evasion is one step above negligence and occurs when taxpayer acts beyond just failing to exercise proper care and diligence, and if such failure was intentional and for the purpose of tax evasion.

In this chapter, we will discuss how the CDTFA must prove such deliberate intent by so called “clear and convincing evidence”. We will explore how this can be proven leaving no substantial doubt as to the truth.

The taxpayer’s intent is the key to impose tax evasion penalties. For example, intent can be shown through consistent multiple tax return under-reporting by taxpayer.

18 What is a California Sales Tax Exemption? [Definition and Examples]

Our ultimate guide concludes with a chapter that discusses sales tax exemptions in California. Although last, this chapter certainly is not the least important by any stretch of the imagination.

Understanding sales tax exemptions is one of the key technical issues that you need to know in a California sales tax audit.

Businesses lose out on millions of dollars in potential exemptions every year and the audit is the perfect time to seek a course correction of any overpayments of sales and use tax that you may have paid

Thank you in advance for reading

“Our Secrets for a California Sales Tax Audit Defense.”

It was a labor of love and our law firm welcomes all questions, comments, concerns, and feedback that you may have about this free resource.

Questions? Speak with us today at
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or (619) 378-3138.



01 What Is California Sales Tax?

INTRODUCTION

How Does California Sales Tax Work?

Most people are quite familiar with the concept of sales taxes on a very basic level. After all, we all buy stuff and, when we do, there is a tax associated with those purchases. Fundamentally, from the consumer's perspective this is what sales tax is: tax on the sale of a good (or sometimes service).

From the business perspective, conceptually sales taxes are a little different. In most cases, selling goods in California requires a permit from the state. The state issues that permit, which equates to permission, and in exchange for that the "seller" is required to collect tax.

Think about this like a contract. California is giving its permission to the business to sell goods and the business exchanges an

obligation to collect sales tax on behalf of the state in exchange for that permission.

So, transactionally, sales tax is paid by the buyer as a part of the purchase price of an item, collected by the business (as permitted by the state) and then remitted to the state of California. The amount of sales tax due is measured by the gross receipts from total retail sales.

In this chapter, I am going to give an overview of how sales tax is assessed in California. If you are a merchant, then consider this a refresher course. If you are concerned whether you are charging the correct amount of sales tax, then feel free to contact me. It is wiser to be proactive than to face a sales audit in the future. Trust me. They are no fun.

It All Starts at the CDTFA

The California Department of Tax and Fee Administration (CDTFA) is the California public organization that administers the state



sales and use tax laws and regulations. The CDTFA also conducts audits, collects unpaid California state sales and use taxes, and administers the state property tax. It also issues and administers sales licenses, permits and use accounts.

This agency regularly conducts audits to ensure that businesses are correctly collecting, recording, reporting and paying sales and use tax.

The revenues from sales and use taxes are used for roads, schools, parks and other vital public programs. As state budgets are always in need of more funds, it is in California's interest to pursue the payment of these taxes aggressively.

Anyone who sells goods or services in California is required to:

- ▶ Obtain the correct sales permit from the CDTFA
- ▶ Collect sales and use tax at the appropriate rate at the point of sale
- ▶ File regular self-reported sales tax returns to the CDTFA on a monthly, quarterly or annual basis
- ▶ Pay any sales and use tax due at the close of each reporting period

There are presumptions of the tax code that the CDTFA follows in its operation and decision-making process.

The CDTFA presumes:

- ▶ All sales are taxable unless specifically exempted
- ▶ Exemptions must be supported by documentation

- ▶ The taxpayer is responsible for maintaining and providing documentation in case of examination or audit

Pivoting to the main topic of sales tax audits, this is part of what makes the audit process so daunting. In theory, reporting and paying sales tax is a simple process, but in practice, it can be anything but. There are a thousand small ways that businesses can miscalculate or underpay the sales tax due to the CDTFA. And, because selling goods is considered a privilege and not a right in California, the consequences of doing things incorrectly can be pretty severe.

In addition, the CDTFA is part of an information sharing program and shares its information with the Franchise Tax Board (FTB), the Employee Development Department (EDD), and the IRS. Therefore, audits, investigations, and adverse consequences from these agencies may be triggered by this shared information.

All it takes to put you on shaky ground with the CDTFA is a bookkeeping oversight or a moment of crisis where funds set aside for sales tax are spent to cover payroll or pressing invoices. Oftentimes, liabilities and mistakes, once started, continue to snowball and become much worse than the original error.

How Sales Taxes Are Assessed in California

There are seven components to the sales and use tax rate; six are state and one is local. Just over half of the sales and use tax goes to the state's General Fund. A portion of a



percent is sent to the state for local safety, statewide education, and local revenue support for health and social services.

The local component receives just over one percent for county transportation and city or county operations.

California sales and use taxes are applied as a base percentage rate (currently 7.25 percent in California) plus any local and district tax. This is calculated from the 6 percent California state base tax rate. The state then adds a mandatory 1.25 percent local tax that goes to the county and city.

However, some districts within California have voted for an additional “district” tax which brings the total rate higher. These district taxes can range from 0.15-3.0 percent. So, sales tax in California can be up to 10 percent or more on certain purchases.

A district can be an entire county or part of a municipality. District taxes are approved by the local voters and are used for special services, such as libraries, or general services. Sales and use taxes go into the state’s general fund to help pay for education, health care, public pensions, and other programs.

So, in San Diego for example, the sales tax rate is 8.25 percent. However, the City of Poway charges 7.75 percent. So, taking the base rate of 7.25 percent, San Diego adds another 1.0 percent for district taxes and Poway adds .50 percent.

Sales taxes can also be collected for special programs or specific areas of the state.

Sales and use taxes are charged at the same rate. The seller is responsible for paying

the correct amount of tax to the CDTFA and almost always collects it from the purchaser. If the seller does not remit the taxes, they are then subject to additional tax charges, applicable penalties, and interest charges.

The CDTFA provides a complete listing of all city and county district taxes and rates on its website.

Sales tax applies to in-state transactions. If you have a store in California that is selling merchandise to a California customer, that is a transaction where sales tax is applied.

Why Sales Tax Fluctuates

While the state sets a base sales tax rate, district tax jurisdictions are allowed to add onto it. The jurisdiction may encompass an entire city, or one jurisdiction may be covered by two different tax districts.

If you are engaged in business within a tax district, you are liable for the state sales tax and any additional taxes levied by the tax district in which your business is located.

Tax rates are changed two ways:

1. Voters approve a new tax
2. An old tax district expires

Either way, just expect that sales tax rate changes are going to occur and keep on top of them. That is the best way for your business to be compliant and it’s one less area for an auditor to pick apart.

California Use Tax

Now, what happens if someone in California purchases tangible personal property from



outside the state? In this case, when the seller does not charge state sales tax, the buyer owes something called to the state of California “use tax.” Use tax is levied at the same rate as sales tax and applies when sales tax is not charged.

The long and the short of it is that California always gets their money.

Use taxes are also levied on goods that make a stop in California in the course of being shipped from the vendor to the buyer, even if the goods did not originate there, were not purchased for use there, or if the buyer or eventual place of use is not in California.

Types of Sales That are Subject to California Sales Tax

Sales tax in California is imposed on “tangible personal property,” which in English means items such as:

- ▶ Toys
- ▶ Antiques
- ▶ Clothing
- ▶ Furniture
- ▶ Giftware

Some services require sales tax to be collected as well, but that can get tricky and we can get into that later in more detail. For example, if the service is “inseparable from the sale of a physical product,” that service may be taxed as well. It includes services such as machine or equipment set-up, fabrication, or assembly.

Installation and repair, on the other hand, are not taxable (usually) but installation and set-up sound like the same type of services. Construction is another service where it can be debated whether sales tax applies.

If you think that is complicated, shipping and handling are worse. California has unusually complex rules surrounding shipping which can be tax-exempt, partially taxable, or fully taxable depending on the situation.

If you do not keep accurate records of your shipping costs, include delivery charges in the cost of the product, or deliver it using your own vehicle instead of a common carrier, the shipping charges may be fully taxable and you, as the seller, are stuck for it.

When it comes to drop shipping and tax nexus, more complications set in.



CONCLUSION

As you see, sales and use taxes are pretty complicated. You have state tax and in some instances, county and city sales taxes on top of it. Use tax is an entirely different beast and it is important to remember that sales and use tax are mutually exclusive, however, there are often circumstances where a merchant will be responsible for both.

If you are starting a new business or want to make sure your existing business is in compliance, give me a call. My firm, Brotman Law, specializes in small business taxation.

We can review your industry, the types of goods and/or services you will be selling and where the transactions will occur.

It is much better to get into compliance at the onset, as opposed to being hit with a CDTFA sales tax audit out of the blue. I can help you get your business on proper course to steer clear of the tax man.



02 What Triggers a Sales Tax Audit In California?

INTRODUCTION

If you have received a notice that your business has been selected for a sales tax audit, you are probably shocked. Why, you ask. You have been filing and paying your sales tax to the state (or so you thought), so what is the problem? In this chapter, I will explain the most risk factors of a sales tax audit.

A sales tax audit occurs when the California Department of Tax and Fee Administration (CDTFA) suspects a business's reported sales have been understated. Most commonly, this occurs in situations where there is a "mismatch" or an incongruence between the sales tax returns filed with the CDTFA and what was reported to other agencies (like the IRS). For example, a business that has different total sales amounts on their sales tax returns and their federal income tax returns is likely to get audited.

In situations where the CDTFA believes that there is understated tax, CDTFA headquarters in Sacramento will send those files to the local district office who will then select the businesses that they are going to audit. In addition to this, random audits can be scheduled as well. The CDTFA has stated that it will audit nearly one percent of active accounts each year.

If you are facing a CDTFA audit and do not know why or know where to turn, call me. I have a wealth of experience in successfully defending clients in sales tax audits. At the very least, I can point out areas where your business is at risk and help you decrease your risk.

Why the CDFTA Conducts Audits

More often than not there is a definite trigger that leads to a CDTFA audit. CDTFA audits are time-consuming and California has limited



resources and auditors to conduct them. So, although we have come across audits that we believe are random, it is far more common to see audits with some underlying motivation. Keep in mind the following:

The goal of the audit is to:

- ▶ Discover oversight or fraud
- ▶ Promote compliance with state tax law
- ▶ Increase revenue for the state
- ▶ Apply penalties when taxes are found to be owed

The CDTFA looks at these factors to identify potential audit targets:

- ▶ Industry involved
- ▶ Past audit history
- ▶ Amount of total sales tax reported
- ▶ Amount of exempt sales reported
- ▶ Ratio of exempt sales to total sales
- ▶ Where the business is located

A large company with a high sales volume or that reports a high amount of exempt sales is more often targeted than those with smaller sales volumes or no exempt sales. If the ratio of exempt sales to total sales is out of line for the industry, that can trigger an audit, too.

Common Sales Tax Audit Triggers in California

Here is a list that we have developed internally of the most common audit triggers.

Failure to Report Sales and Use Tax to the CDTFA

This one is pretty obvious and it is not that hard for the CDTFA to figure out. If you have a website or phone number for your business but are not in the CDTFA's system, or if you are paying payroll tax or other tax in California but have not registered for sales and use tax, you have a big red target on your back.

The CDTFA has also been known to look for business registrations and to cross-reference federal tax filings in an attempt to look for businesses that may be evading sales tax.

Vendor and customer audits, as well, are prime sources of information. If you or your vendors are audited by the CDTFA, it can trigger follow-up investigations by other agencies. Even if you are located outside the state, if you sell anything in California, or it makes a stop in California while being shipped elsewhere, you may be assessed a tax and could be targeted for a CDTFA audit as well.

Consistently Reporting or Filing Your Sales Taxes Late

If you have a history of failing to report, file or pay sales tax, the CDTFA can become suspicious of your bookkeeping practices. After all, continually procrastinating with the filing and payment of your sales taxes does not inspire a lot of confidence.

The CDTFA also understands that if you are struggling to pay the tax, there is an incentive to under-report sales as well or to take other reporting shortcuts to try and minimize your sales tax burden.



High Exempt Sales or Deductions Taken on the California Sales Tax Return

Reporting of tax exempt sales is not uncommon, especially among certain industries, but going back to the presumption that all sales are taxable unless proven otherwise, a high amount of exempt sales or deductions taken against total sales may trigger an audit. Overstating deductions in order to reduce the amount of tax due to the CDTFA is equally as prevalent as understating sales.

Additionally, the rules and regulations governing exempt sales are complicated, and there is a high tendency towards misunderstandings and mistakes. Tax due to California as a result of a CDTFA audit can also be caused by innocent oversights and negligence as well as willful fraud.

To reiterate, if you have a high amount of exempt sales or deductions taken against total sales, the CDTFA may likely audit you in order to find out why.

You Have Been Audited in the Past

This is especially true if you have been audited in the past for a specific issue that you have not yet cleared up. If you have been audited once, you are likely to be audited again if the CDTFA feels that another audit will yield additional tax due. If you have not fixed the problem, you will be charged again until the CDTFA is satisfied you are doing things right.

One of Your Vendors Was Audited by the CDTFA

This is called ***audit by association***. We mentioned that an audit of one of your vendors could trigger an audit of your business. If you learn that one of your vendors or suppliers is being audited, do not be surprised to find an audit letter addressed to you in the near future.

Large companies get audited regularly, and these can trigger “whipsaw audits” on all of their clients and vendors. This is one of the ways that smaller businesses that previously flew under the radar attract notice.

Your Business Had a Major Change

If you acquired a business, opened a new location, or closed one, the CDTFA may become interested in your sales tax records. It also pays attention to when there is a sudden increase or decrease in sales. This is why businesses that go through some sort of a transition may be at risk for an audit.

If you have closed your business recently or try to sell it, you can still be audited, and the CDTFA has been known to attempt to assess liability against as many people as possible in order to make sure that any tax collected is ultimately paid. Anyone who may have been involved in dealing with sales tax in a business can find themselves held responsible and required to prove their innocence.



Your Industry is Known for Substantial Non-Compliance

Some industries just have a reputation for sales tax non-compliance, especially businesses dealing in cash:

- ▶ Bars
- ▶ Restaurants
- ▶ Grocery stores
- ▶ Car dealerships
- ▶ Construction
- ▶ Gas stations
- ▶ Liquor stores

Cash is easily “lost” or hidden, but the CDTFA wants every bit of it recorded and reported. Scaring other cash businesses and industries that are big on cash into compliance is one reason that these businesses are audited frequently. It is easy to cheat when things are in cash.

Cash businesses and others that are notorious for non-compliance are also frequent targets for CDTFA audits because they tend not to adhere to sales and use tax law as a matter of course. There may be a lack of internal controls, or the requirements are not understood.

If your industry has a reputation for tax irregularities, it is probably only a matter of time even if you have not done anything wrong.

A CDTFA audit is nobody’s idea of fun, but it happens. Sometimes, the reason for the audit is out of your control, but these common factors identify those who have potentially a greater risk.

Sales Tax Audit Statute of Limitations

There is a time period within which the CDTFA must audit your business. This is the **statute of limitations**. Once that time period has passed, they cannot assess or collect taxes or penalties for those years.

In California, the general statute of limitations is three years for taxpayers who have filed tax returns. That means the CDTFA has three years within which they can audit those returns. However, if you fail to file tax returns, the statute of limitations is eight years.

There are some exceptions which could extend these statutes of limitations:

- ▶ If you have an amount due and payable for tax reporting periods before January 1, 2003
- ▶ You did not participate in the 2005 tax amnesty program
- ▶ Fraud or intent to evade tax is discovered
- ▶ From January 1, 2009, if the CDTFA has audited a company that has gone out of business, they can issue a deficiency determination (that is, a bill for unpaid tax and penalties) to a responsible person within the earlier of the following two periods:
 - ▶ “Three years after the last day of the calendar month following the quarterly period in which we (the CDFA) obtain actual knowledge of the entity’s termination, dissolution or abandonment. (Knowledge through its audit activities,



compliance activities or written communication by the business.)”

- ▷ “Eight years after the last day of the calendar month following the quarterly period in which the entity was terminated, dissolved or abandoned. If the business files a notice of termination, dissolution or abandonment of the entity with a state or local agency other than the CDTFA, that filing will not constitute actual knowledge by the CDTFA of the filing.”

However, the problem with California sales tax audits is that once the audit is open, California can essentially force an extension of the statute by just assessing the taxpayer if they refuse to extend the statute.

With essentially the ability to control the pace of the audit, interest can continue to build on any adjustment in tax that comes at the end of the audit. It is, therefore, important to control the pace of the audit and there is some strategy built around how to leverage the statute of limitations in an audit to your advantage.

What the CDTFA Auditor is Looking For

The CDTFA’s auditors are looking for mistakes, errors, and omissions. They are looking at your data and they are examining the relationship that different data has to other data. They are looking at the returns that were filed and they are looking for any errors that exist.

Within your data, the auditor is then going to look at different things. They are going to look at purchases to make sure that the appropriate amounts of tax were charged and paid, they are going to look for exemption certificates with any resales that were made, they are going to look to make sure that shipping charges were appropriately taxed, and they are going to go through and look at various issues that are specific to your industry.

The CDTFA is not auditing you by accident. You got selected for audit because they are looking for something (whether or not you are subject to a random audit). They believe that the effort that they put into the audit is going to yield some error in the amount of tax that you paid, so it is the auditor’s job to go through your data and try and find mistakes.

If they do not think they are going to find any mistakes, they cut bait. However, keep in mind that the law is very complicated and auditors are very good at finding mistakes.

The way you mitigate the auditor going on a fishing expedition is to present something that is very tight, very concise, and to control the scope of information that you give to them. The more tightly controlled the data you are providing to the auditor is, the more that you are going to be able to limit mistakes in your presentation, and the less likely that the auditor is going to make adjustments during the course of your sales tax audit.



How CDTFA Auditors Find Mistakes

The most common errors are discrepancies between primary source data and the sales tax returns that were filed. For example, if the sales on your federal income tax returns do not match the sales that were filed in the sales tax returns, the auditor will find that error and figure out a way to calculate what the true percentage of sales were — from the auditor’s perspective.

However, they have other ways to find out if you made a mistake. They can observe your business and apply certain tests or procedures to make sure the sales and amount of sales tax is properly reported.

Processes include:

- ▶ Statistical sampling
- ▶ Analysis of transactions
- ▶ Markup analysis
- ▶ Credit card percentage tests

If you own a bar or restaurant, an auditor may even perform a “pour-over” test while undercover to confirm appropriate amounts are being dispensed. Auditors can also choose to contact your vendors directly for information.

Bottom line: CDTFA auditors have different methods for analyzing data and different methods for finding mistakes or assessing you for different items on your return. The important thing to remember is that when you are in a CDTFA audit, you can consider yourself under the microscope.

CONCLUSION

There are too many reasons as to why your business was selected for a CDTFA audit to list here. Usually, it was a combination of factors that brought you to their attention. In this chapter, I outlined the most common audit triggers and areas of greatest risk for most small businesses. Unfortunately, certain industries like restaurants, get hit more frequently and harder than others. That is just the way it is.

However, if you have been through an audit, you know what it was like and I doubt that you are eager to repeat the experience. In that case, I can help you review your business practices and clean up your recordkeeping to stay off the CDTFA’s radar. Likewise, if you are going to be audited, give me a call right away and I can help you plan an audit strategy to minimize your liability.



03 Risks for Your Small Business in a CDTFA Audit

INTRODUCTION

Before going any further in the process, we should address the risks associated with a California Department of Tax and Fee Administration (CDTFA) audit. By far, the biggest mistake that we see taxpayers make and the biggest area of risk that they have is the dangerous assumption that because they “did not do anything wrong in the sales tax audit, they do not have anything to fear.”

That statement conveys a fundamental misunderstanding of the way that sales tax audits work. As a reminder, the auditors are looking for mistakes in how the taxpayer filed their sales tax returns and, in the amount of tax that they paid.

So, the auditors are devoting a significant amount of time and energy to going through all of your data and verifying your taxable sales. The reality of the situation is that even if you do not feel like you made a mistake, the auditor ~~may~~ will find some.

The auditor does not have to find “actual mistakes.” Sales tax auditors can and often do make “estimated assessments” using statistical samples applied to a larger population of data.

The main problem with a sales tax audit is the amount of data that may need to be dealt with during the course of the audit (over a three-year period) and a conflict between the limited amount of time that the auditor has to work the case file.

So, to save time and money, the CDTFA will have their auditors conduct “statistical sampling.” This is where they will examine random transactions over the past three years from your books and extrapolate them as representative of “average” volume and revenue generated in your business. They will go from there to see if you collected and reported the correct amounts of sales tax.

Is this fair? No. That is why I advise you to have a professional represent you in a CDTFA sales tax audit. What sets Brotman



Law apart from other firms is that I have extensively studied statistics. They do not teach you that in law school and it is important. It can make or break the outcome of an audit.

In this chapter, I discuss audit testing and sampling as well as other errors that can get you into hot water with the CDFTA.

How Audit Sampling Really Works

For instance, take a business with 100 average daily sales. Over a year, that business has more than 36,000 transactions and over the standard three-year audit period, you are dealing with more than 100,000 transactions. No California state auditor has the time to deal with that large number of transactions

The auditors combat this problem by resorting to statistical sampling. Out of more than 1000 days for a three-year period, auditors will lean on two-to-three days of test data and apply that to the population. Whether or not you hold a PhD in statistics, I think that you will agree that for the California sales tax auditors to take .2 percent of an audit period and to treat that as reflective of a business's sales for an entire three-year period is a complete stretch.

Think of all that has happened to your business in three years. Is it fair to say that nothing has changed?

Here is the problem in a mathematical sense. Let's say the auditor's average sales over a two-to-three day period is \$30 off from the true average of your sales over the same

three-year period. Thirty dollars is not a whole lot. However, multiply that amount by the 1,095-day audit period and you are left with \$32,850 in tax due — not to mention all the penalties and interest you are accumulating.

Under CDFTA audit guidelines, sales tax auditors may resort to these “indirect” methods of testing. When the auditor goes to indirect methods of testing, they are using statistical samples to arrive at what the proper conclusion is. However, statistics are nothing short of educated guesswork and the problem is that when the state guesses, it usually guesses wrong.

The auditors tend to go after low-hanging fruit and are not going to dive into a lot of very complicated situations. They are going to go after quick wins and a lot of the quick wins happen when they apply indirect methods of testing.

The flip side is that the auditor is going to put the burden on the taxpayer to produce documents to refute the auditor's conclusion. You should not be guilty until proven innocent in a sales tax audit but sometimes, that is how it goes with a sales tax audit. Once the auditor has come to a conclusion in your case, it can be very, very hard to disprove.

How Serious Errors on Tax Returns Trigger Audits

Unlike other forms of audits, serious errors in sales tax audits are usually pretty easily discoverable. One of the biggest mistakes that people make is they under-report their sales tax returns, but their federal income tax returns show the true amount of sales.



The auditors take, what we call, **big five data**: your sales tax returns, your federal income tax returns, your internal accounting, your bank statements and your 1099-Ks, and they will line up all that data together. That is a pretty good indicator out the gate of if there is a discrepancy or whether or not your reported taxable sales are accurate.

Anyway, this is a big problem because it is very easy to see serious errors right away. The first thing you need to do is understand how serious the error is and whether or not there was any intent behind it. If there was intent and you potentially fraudulently filed the sales tax return, that is a different issue.

If there is a serious error and it is isolated to one particular quarter, you are better off highlighting it for the auditor and isolating the error rather than letting them turn a molehill into a mountain and go through the entire audit with the expectation that that error is going to continue.

The best thing that you can do with errors is either, A) admit them to the auditor flat-out, or B) do damage control, and mitigate the issue as much as possible. By mitigating the issue, you are going to reduce your liability, you are going to shorten the life of the sales tax audit and the error is not going to seem that serious when in question.

Errors That Can Send You to Jail

If the CDTFA thinks you are willfully under-reporting sales tax and/or fraudulently filing returns, you can and will receive a criminal referral. One of the biggest jobs that we have at the beginning of an audit, is when

somebody comes to me and says, "I have under-reported on my sales tax and now I am getting caught," is to mitigate any evidence that there was any willful conduct on behalf of the client.

The goal with any potential criminal matter is to keep it civil and to minimize the damage as much as possible. You can trigger a CDTFA fraud referral based off of that, but also, even if you are not going to go to jail for the errors that you caused on the sales tax returns, you have to be mindful of penalties.

The CDTFA has a very rigid penalty scheme, particularly with respect to fraud penalties and sales tax that was collected but never paid to the state.

In addition to worrying about going to jail, you need to be worried about the escalating liability, because an escalating liability, once it gets into collections, can create a huge problem for the taxpayer.

While you are in the examination phase of a CDTFA audit, you want to make sure you can make the biggest adjustments possible and eliminate any notion that there was willfulness behind your actions.

Types of Civil Penalties

Sales tax audits have different types of civil penalties. Some penalties are more severe and some penalties are less severe. Generally, penalties will range anywhere from 10-50 percent, but the biggest kicker with sales tax penalties is that they can stack on top of one another.

For example, suppose a client did not remit all the sales tax that they collected and they



also failed to file a return. This client could be looking at a 40 percent penalty for the failure to turn over sales tax and a 10 percent penalty for each return that was not filed. As you can see, this can add up pretty quickly and it leads to a lot of problems in the context of the audit.

Usually, the CDTFA will reduce the penalties down to a manageable level. For example, if you have 12 quarters of sales tax returns that you did not turn in, they are not going to hit you with a 120 percent penalty. Still, sales tax penalties are pretty severe. The CDTFA often leans towards the stronger end of the penalties, at least at the district level.

When we handle a sales tax audit, one of the biggest areas for negotiation, is what the ultimate penalty structure is going to be for the client. We push on behalf of our clients for zero or very low penalties. This is contrary to a lot of the behavior that you see in a sales tax audit, but if you play your cards right, you can mitigate penalties or avoid them entirely.

Dual Determination

A **dual determination** happens when you have a situation with a business, that either accrues payroll tax liability or sales tax liability. When you have a payroll tax or sales tax liability with a business, the state or the IRS can hold the officers of the company personally responsible if they did not pay those taxes.

There are certain taxes that we refer to as **trust fund taxes**. Those are monies that are held in trust for the benefit of somebody else. A common example of this has to do with payroll taxes.

When you do not pay payroll taxes, there is a portion of those payroll taxes that are the employer's responsibility but there is also a portion which is the employee's responsibility. The government can hold you responsible for the employee's portion of those taxes.

Sales tax liabilities are not a trust tax within the definition of the law (according the 9th Circuit). However, they still have dual determinations associated with them. Essentially, because a business is liable for taxes that they collected and did not remit, the CDTFA will determine that the business owner should be held dually responsible for taxes.

What a dual determination really hinges on is who is responsible for the nonpayment of taxes, whether they had knowledge of or were aware of the fact that taxes were not getting paid and whether they could have done something to pay those taxes.

Generally speaking, if you are aware of a liability and you chose to pay other creditors that were not the government, they are going to hold you liable for that.

The dual determination process is a very strategic one because when you have a situation where you have multiple officers, the state or the feds tend to cast a pretty wide net. They will just lump everybody together and they do not care who they assess because it is just more avenues for them to attack and try and get money out of.

When you have a situation where you are going to have unpaid payroll taxes or unpaid sales taxes, you want to plan this out strategically.



We actually start planning these things out at the beginning of a collections case when we walk into a situation and realize that there is a business with multiple years of unpaid tax liability or even multiple quarters of unpaid payroll taxes. We will start looking at the analysis from what is going to happen if this goes forward and there is a dual determination. Who is the responsible officer? How are we going to get them out of this?

When we negotiate a strategy for paying off payroll taxes, we think about the consequences to the individuals that may or may not happen later. By the way, we do this during audits. We do this for a variety of processes when you have a business and there is the potential for the officers to be held responsible for the taxes.

CONCLUSION

Owning a small business is risky no matter how successful you are. There always seems to be another landmine lurking around the corner. Do not let sales tax problems be one of them. That is why I walked you through some of the biggest risks to your business in the area of sales tax reporting and collection.

I also gave you a heads up on audit sampling and testing. You really do not want to expose your business to that kind of risk and face

a huge sales tax liability on guesswork. You may as well roll dice or flip a coin.

Working with an experienced firm such as Brotman Law can significantly reduce your risk exposure. Our strategy is to gain control of the audit and manage the information that the auditor has access to. Actually, it is a win-win situation. The auditor does not have to spend as much time reviewing transactions and the probability of you walking away with low to no liability has suddenly increased dramatically.



04 The California Sales Tax Audit Process

INTRODUCTION

When you received a notice from the California Department of Tax and Fee Administration (CDTFA) that your sales tax records are going to be audited, you probably broke into a cold sweat. You thought of those old movies and TV shows where the curmudgeon auditor is sitting at a tiny desk in the basement, wearing his green visor, holding a cigarette in one hand, and pecking away at a calculator with the other. A single light bulb dangles overhead.

Well, it is not quite like that today. First of all, smoking is not allowed, but the premise is the same. The auditor is going to go through your records, make calculations and decide if you owe back sales tax. This also leads to a quick aside ... treat the auditor kindly and give them a decent space to work if they work out of your office — which you should try to avoid at all costs. (I go into more detail about forging a positive working relationship with your auditor later in this chapter.)

What I recommend is that if you are facing a CDTFA tax audit that you call me. One of the specialties of my firm, Brotman Law, is representing small business clients in sales tax audits. We know the territory and they do not and they are not necessarily supposed to. In this chapter, I am going to walk you through the steps of a sales tax audit so you will know what to expect. Remember, knowledge is power and you want to make sure that the person who holds the power in your audit is you and your team.

Step One: The Notice of Audit

When you are the target of a California sales audit, the process starts by receiving a notice that you are being audited. First, the CDTFA will send you what's called an audit engagement letter that tells you the terms of the audit, provides you a preliminary list of documents to gather, and a request to contact the auditor by a certain date.



The government's audit request is usually for 12 quarters or three years of information. The auditor will also usually request a phone call to schedule an in-person audit meeting to review records and to go over any preliminary issues.

On the call, the auditor will usually have an agenda and will move through some preliminary questions that they have about your business, its recordkeeping, and how your company does business. Because California sales tax audits are very technical, auditors are used to taking the lead in the conversation, and so will drive forward. If you let them, they will control the pace of the audit and the scope of the information requested.

Generally, on the first call is where we push back a little bit (albeit politely). You do not actually have to give them all three years of records just because they say you have to, and the plan for the audit is open to negotiation.

The idea is that you want to agree with the auditor on a scope of documents being requested and why. You also want to agree on a general audit plan for making sure that this is being handled appropriately, it is being handled efficiently, and that progress is being made to move the audit forward.

The California sales tax audit process is highly fact-specific and it is highly fluid, depending on what is being audited, why it is being audited and so forth, but the important thing to note is that much of the audit itself is open to negotiation.

Then, based on that agreed-upon plan, the auditor will give you a period of time, usually 30 days, to get your documents together to present them.

Step Two: Develop a Sales Tax Audit Plan

Good preparation and the tone of your first interaction with the auditor are very important, so you should take care to comply with all of the requests in the letter. You will have some flexibility in scheduling the audit and can ask for a reasonable amount of time to collect the required materials. Two or three weeks is standard. If you need more time you may be required to sign waivers.

A Waiver of Limitation is a document which will extend legal requirements if the auditor finds additional tax liabilities owed. As mentioned before, the CDTFA usually works with a statute of limitations: a three-year limit within which they must investigate and charge delinquent taxes in your tax return. This waiver extends that time limit.

A Waiver of Credit Interest is a document which will absolve the CDTFA of interest owed if the auditor finds a refund or credit owed to you.

It is in your interest to have a tax attorney review your case before you sign a waiver or other document which could affect your rights in the audit.

The next thing that you should do in the California sales tax audit process is to compile your key sources of data, including but not limited to, your federal income tax returns, your sales tax returns, your profit and loss statements, your sales summaries, your 1099-Ks, your merchant accounts, and any other piece of data that is a primary source document with relation to your taxable sales.



You want to take a look at this data and gather it all together because it is going to be one of the important starting points of your sales tax audit. It is the relationship between all these different data points that is going to impact the decision of whether the auditor moves into statistical sampling.

Once all this data is compiled, you need to assess your risk and potential exposure in the audit. Understand that there is a reason why the CDTFA selected you for a sales tax audit, if you can identify that reason, you can take steps to mitigate it prior to presenting any information to the auditor.

When you are looking at risk, it is a good idea to get a tax professional involved because most people are not comfortable with assessing their own sales tax risk. At the very least, you should have a consultation with someone so that you can understand where the risk is, you can understand what the playing field is, and you can understand how to appropriately deal with the sales tax audit.

Notice that in all these steps, we did not say to contact the state. Before having any contact with the auditor, you want to make sure that you gather your documents together; at least an initial sampling of those documents so that you can look for discrepancies between those key areas of reporting and you want to know what your risk is going to the audit.

That way, you can understand how to develop an audit plan with the auditor that is going to be mostly in your favor. We recommend taking those actions first and then reaching out to the auditor in order to begin the audit. This way you will be fully prepared to defend yourself against the CDTFA.

Step Three: Get on Your Auditor's Good Side

The key to surviving a sales tax audit is to maintain that delicate balance between being helpful and cooperative towards the auditor and looking out for your best interests. Common courtesy can often be the deciding factor between a favorable outcome and having the “book thrown at you.”

There are two important things to keep in mind before the proceed with the audit:

1. Before you begin your preparations, be ready to comply with the auditor's requests but do not volunteer additional information.
2. Do not sign anything without careful examination because the auditor is unlikely to explain the consequences or agreements. It is up to you to research and clarify what you do not understand.

You can do this with an air of professionalism, but it is important to operate in a self-preservation mode. It pays to be congenial and accommodating in your relationship with the auditor, but remember that you are not required to volunteer information that has not been requested.

Like your parents told you, first impressions are important. Display your best manners and a helpful attitude. Respond promptly to meeting requests even if it is to negotiate a time better suited to your business. If you have been courteous, the auditor will be more likely to be flexible.



After you have agreed on a time and a place for the audit, your next step is to collect and review the documents requested for the time period specified in the letter of engagement. That list is only the starting point, so you can expect further records to be required as the audit progresses.

Step Four: Complying with Records Requests

One of the key factors in the California sales tax audit process is documents and document production. You will have received a list of records and documents in the audit engagement letter telling you what you must have ready and available.

Typically, the auditor will want to look back over three years (12 quarters). Providing these documents neatly prepared and organized conveys transparency and a willingness to work with the auditor, which can make the process more comfortable.

If a request is unclear, ask the auditor to explain. Some requests are generic and may not apply to your particular business. Talk about any alternatives the auditor may want instead.

If you are asked to prepare documents for a time period that is not representative of how your business normally operates, you may be able to negotiate with the auditor, which will go more smoothly if you have been reasonable and open throughout the process.

Some examples of common records requested include:

- ▶ Accounts Payable (A/P)
- ▶ Accounts Receivable (A/R)

- ▶ General Ledger (G/L)
- ▶ Federal Income Tax Returns (FITR)
- ▶ Sales and use tax returns and worksheets
- ▶ State and federal income tax returns
- ▶ Sales invoices
- ▶ Purchase invoices
- ▶ Till receipts
- ▶ Property tax statements
- ▶ 1099-K records
- ▶ Documentation supporting exempt sales, such as resale certificates or freight bills, purchase orders, paid bills, invoices, contracts and customer exemption certificates

The process is not meant to be inconvenient, but transactions can get lost, chargebacks occur, returns are not accounted for ... clearly things happen. If the auditor is unable to follow a trail or find all the documentation, be willing to cooperate.

If you do not assist, the auditor may make an assessment based on a lack of information. Everyone will work harder, and the outcome may not be positive.

It is much better to keep a transaction out of an audit finding at the start than fight to have it removed from the findings later. If the information cannot be found, and if the CDTFA district administrator approves, CDTFA staff can request information directly from your financial institutions, either with your approval or by subpoena.



Once again, the key to preventing these more drastic measures is to sit down with the auditor and develop an audit plan. That way, you can often streamline this document request down to something that is much more manageable. Just keep in mind that the more information you give the auditor, the more avenues of attack that you expose yourself to.

You want to make sure that you control things and that you are presenting information in a clean and consistent manner. That is the best way to get through the document part of a sales tax audit.

CONCLUSION

Hopefully, after you read all of this, you are wise enough to not try to defend yourself in an audit without professional representation. We see too many naive taxpayers blithely comply with any and all requests of the auditor and only serve to dig themselves in deeper.

Remember what I said about power in the introduction? Do not let the CDTFA get the upper hand in your audit or your position can start circling the drain pretty quickly. That is why you need an experienced tax professional on your side. I have the

advantages of my experience and I know most of the auditors we would be dealing with. That is worth a lot.

If you persist in wanting to represent yourself, then make sure you have memorized this chapter. Make sure you treat the auditor well, do not sign anything without reviewing it thoroughly and do not just hand over documents without understanding why they are being requested. Good luck and if you change your mind, I am just a phone call away.



05 How to Prepare for a California Sales Tax Audit

INTRODUCTION

Preparing and organizing materials for a California sales tax audit is by and large a unique process based on the individual facts and circumstances of each case. Handing documents to California Department of Tax and Fee Administration (CDTFA) auditors should be in support of whatever narrative your business is going to present in its defense and, by no means, should you haphazardly produce documents for the auditor.

Every action taken in a sales tax audit should be designed to move you as quickly through the audit process as possible with the least amount of liability. That is why I strongly encourage you to have an experienced tax professional represent you during a CDTFA sales tax audit.

My firm, Brotman Law, has a successful track record of defending our clients in sales tax audits. We have been doing this for years and actually know many of the

CDTFA auditors. It is a whole lot easier to strike a deal with somebody you are familiar with than to strike out on your own against a complete stranger.

If you are looking down the barrel of a sales tax audit, please call me. Keep reading this chapter to see what you are up against, then pick up the phone.

Common Problems in Sales Tax Audit Preparation

Our firm has done a lot of sales tax audits and we can speak very generally about some of the problems that we see most often with our clients or that we have encountered through the years.

When the Numbers Do Not Match

When you file a sales tax return, it gets reported to the CDTFA. In the evaluation process to determine whether they are going



to audit you, the CDTFA is looking not only at your taxable sales and your total sales, they are looking at your federal income tax returns and they are looking at the information that was reported on your 1099-Ks and any other publicly available information that they can find.

The biggest problem that people have right off the bat is sales tax returns and federal income tax returns not matching. You are reporting a higher or lower amount of the sales than you are on your federal income taxes.

There may be a natural explanation for it. You may have bookkeeping adjustments, you may have labor built into gross receipts, or you may have sales that were not in California or you may have exempt sales. There could be many reasons, but the problem that we see with clients is the clients fail to match their data and or they go in the audit without a proper explanation for why their data does not match.

The issue with this is that it suggests underreporting of sales tax liabilities, even if such underreporting did not occur. This, by the way, is how the majority of people who are under-reporting sales tax get caught.

Lining up all your primary sources of data (sales tax returns, federal income tax returns, internal accounting, sales summaries from POS, merchant account statements, 1099-Ks, et) is critically important so that you can see where the gaps are in information or what needs to be explained. Thinking that the auditor is going to be able to conduct the same analysis and come to the same conclusion about a discrepancy in your data is a fallacy. So, at the outset of the audit, get

organized and be prepared to put your ducks in a row.

Fix Invoicing Problems Before the Audit

Most invoicing systems were not built to sustain scrutiny from a California sales tax auditor and the second most common error that we see in sales tax audit preparation has to do with invoicing. We see more mistakes on invoicing and it is so hard to build a narrative when you do not have invoices that support it.

To be fair, most of the “mistakes” that we see in the context of audit preparation are benign. Things like not separating shipping charges properly, people not accounting for time and material costs, things being billed individually, or a failure to adjust sales tax rates for the proper district are small and seemingly harmless mistakes in the context of your business operations. However, from a sales tax perspective, it is these little paper cuts that can add up and lead to a gaping wound.

Your invoicing should be screened for issues prior to meeting with the auditor. While we are not recommending that you doctor invoices, we do suggest you perhaps provide some additional context when invoicing mistakes arise. By doing so, you are going to be able to take something that could otherwise turn into a big issue and neutralize it before it even reaches the auditor.



How to Overcome Poor Recordkeeping in Sales Tax Audits

This is a killer. Poor recordkeeping and the inability to produce accurate primary source data is what dooms most businesses to relying on statistical sampling to complete an audit. Also, the task of refuting that sampling is made harder by a lack of historical books and records or accurate internal accounting.

You must be able to produce supporting documents for your return and potential audit. Here is a listing of some common documents and statements the CDTFA requires you to retain:

- ▶ Resale certificates
- ▶ Purchase orders
- ▶ Bills of lading for interstate commerce
- ▶ Delivery receipts
- ▶ Freight invoices
- ▶ Correspondence

For resellers, whenever you sell an item to be resold by someone else, obtain the appropriate documentation from the purchaser such as a resale certificate. Retain any old certificates as well; maintain and update your records periodically.

Required records:

- ▶ Sales invoices
- ▶ Cash register tapes
- ▶ Sales journals
- ▶ Purchase invoices

- ▶ Exemption certificates
- ▶ Working papers used in preparing your tax return

Recordkeeping is one of the first things that we address with a client in an audit setting. We use a phrase called the “integrity of data,” which means that the more complete and robust the data we provide the government is, the less likely the conclusions drawn in that data are likely to get challenged. You want to first identify any deficiencies in your records and then work to build supporting documentation around them.

Eliminate Sales Tax Law Confusion

There is a fair amount of confusion surrounding sales and use taxes. Even among tax professionals, this is a very complicated and highly specialized area of the law. What we see among some of our clients who have tried to start the audit process is that there is a fundamental misunderstanding between what they believe the law is or the right way to do things is and the way that California interprets the law.

People operate under the false assumption that because they pay all their sales taxes in the manner that they think is correct they are not going to have any problems with the auditor. They take the attitude that because they “check the box” on doing what they are supposed to be doing (filing sales tax returns and paying) that they can just show the auditor some documents and everything will be OK.



However, do not forget that there is a reason that California has chosen to audit you and that your audit was no accident. Someone actively selected you for audit based on something that they saw. And, unless you have had an experienced person review your sales and use tax compliance recently (and even then), you should always go into a sales tax audit thinking that you have a problem because you *will* have a problem.

Your problem is that you will have an auditor who is going to look over your books and potentially make a correction that might not be in your favor. Imagine you had a police officer following your car around while you are driving. Do you know the vehicle code chapter and verse? Are you sure you are not doing anything wrong?

The long and the short of this is that you can prepare for the audit by knowing the law and knowing how to defend yourself if the auditor starts to challenge you. The auditor is not a California sales tax attorney, so you can use the fact that they have no legal training to your advantage in the audit.

The Sales Tax Audit Meeting

If the preparation gets handled correctly and issues are spelled out as clearly as possible, the first meeting with the auditor should go pretty smoothly. You are going to want to make the materials produced to the auditor as clean and as easy to work with as possible, even if it requires a bit of extra effort on your part. Auditors prefer electronic data because it is easy to work with and manipulate into their audit reports. We recommend not handing over everything

(stay within the scope of the request), but if it is possible to provide electronic data, you want to do so in most circumstances.

Meet With Your Sales Tax Auditor

Go meet your sales tax auditors, spend as much time as possible with them and drive them completely crazy. In all seriousness, the way that we have had the most success in the firm is by face-to-face contact. The more time you spend with these auditors as individuals, the more you get to know them, the more they will like you and the more latitude they will give you.

People naturally like to do business with people they like. Once you get to know, like, and trust somebody, then you start to develop a relationship with them. One of the big reasons we are successful is because we deal with these cases over and over and over and over and over again.

We deal with the same people repeatedly. I might not know every auditor in the San Diego office of the CDTFB but I know a ton of them. It is really important and we have developed that relationship because of face-to-face contact and because an auditor or manager who I am having a disagreement with is not going to take an unreasonable position.

They know they have to see me again and again and again and again and again. It is not like we are going to take a hard line on this case and hope this person never shows up again because there is a level of contact and a level of familiarity.



If you decide to represent yourself in the CDTFA audit — which I do not recommend — but if you do, you want to have as much contact and as much touch point with your auditor as possible. You are not going to be able to influence them or buy them dinner, or bribe them under that table, but just having that familiarity, and developing trust and rapport is a very important strategic tactic.

I would absolutely recommend that you go and meet with your sales tax auditor. I would not recommend that you bring them into your business, though. I recommend that you actually go meet them at the CDTFA offices. The meetings will be a lot shorter. You will get the time to interact with them in the conference room, you can walk them through your documents, and you just give them a much better presentation by doing that.

The Alternative to Meeting with the Auditor: CDTFA Managed Audits

A managed audit is when you sit down with the auditor and agree to basically perform a self-audit. A managed audit formulates a plan that is a contract and it is found under CDTFA Form 526.

A managed audit can be a good idea in certain situations because what you are doing is essentially filling out the auditor's work papers for them. You submit the work papers to the auditor along with some documentation for them to verify and if everything turns out okay, then the auditor will bless the audit.

In doing a managed audit, you have the potential to cut your interest rate in half. That can be pretty good savings depending on how much your liability is. However, the savings in terms of the interest can be outweighed by the length of time and the resources it takes to complete the audit.

Managed audits take a lot of work and if a client lacks the internal resources to do the audit for the auditor, it can be a huge waste of time, cost and energy.

The managed audit decisions should only be made with a tax representative in terms of discussing the strategy for the audit. Agreeing to a managed audit is a significant burden and can be a huge amount of work, so the decision should not be made lightly.

If you do the managed audit properly and you fill it out and turn it in and it reduces the amount of time that the auditor takes to look at the audit, you can set yourself up for success in certain situations.

How Long Does a Sales Tax Audit Take?

Sales tax audits take a lot of time; at least six months. Sometimes, they can stretch out to nine months. There are usually multiple rounds of back-and-forth particularly with statistical sampling, when things get complicated. That is generally the way that things will flow during the course of the audit.

Again, the most important time in the audit is the beginning, because you are setting the tone for the audit. You are creating a plan and then it is just about executing it.



If you do that, the audit process hopefully should work in your favor. Again, my advice in a sales tax audit is to always retain an expert. You need to have somebody in your corner who is going to go through these issues with you, help you develop your plan, negotiate with the auditor and make sure the statistical sampling is fair. That is really, really critical for many reasons.

What you do not want is when the audit starts to get off-track, because that is where a lot of the problems get kicked up. The clean-up for that is much more expensive, much more time-consuming, and much more of a headache than if you just did it right the first place.

Challenging the Tax Auditor's Findings: After the Sales Tax Audit

Once the auditor has finished their investigations, there will be an exit conference where the findings are reviewed, and the auditor will prepare a **Report of Field Audit** or a **Report of Investigation**. A CDTFA supervisor may be in attendance as well.

Once the findings are presented, you have the chance to disagree with them and explain why. You will be given time to gather documentation and present any information you think supports your case.

After you have made your argument, the auditor may do one of three things:

- ▶ Adjust the findings
- ▶ Request more evidence
- ▶ Arrange another meeting to discuss your case

After the official report is filed, you will later receive **A Notice of Determination** (billing), which will outline the taxes and/or fees you owe or **A Notice of Refund**.

If the CDTFA owes you a refund, they will first check to make sure that you do not have any other outstanding tax liabilities with any state agency. If you do, the refund will be applied to that tax debt. If you do not, they will issue a refund warrant usually within four to eight weeks of the report of field audit.

If you do have a sales tax liability assessed against you and do not plan to appeal, you will need to pay the amount due within 30 days of the assessment.

If you fail to pay within that time period, you will be charged a penalty of 10 percent of the amount owed. Interest is also charged on the amount owed and the interest rates vary. Persistent failure to pay will expose you to aggressive collection actions by the CDTFA such as liens, levies or seizure of property and assets.

If you still disagree with the findings, you will need to file an appeal ("petition for redetermination") within that 30-day period. The CDTFA has a lengthy appeals process, and at each stage you will be required to make your case.

In an audit situation, the reality is that you are generally assumed guilty until proven innocent.

Meeting With the CDTFA Supervisor

If the supervisor was not present at your exit conference, you may now request a meeting with that person if you and the auditor are



unable to reach an agreement about the audit findings.

You will again have the opportunity to present your information and reasoning while the auditor prepares a Report of Field Audit or a Report of Investigation. The CDTFA supervisor will analyze both sets of data.

If you are still unable to reach an agreement on the outcome of the audit, you may meet with a CDTFA representative within 10 days of your meeting with the CDTFA supervisor. Otherwise, you may consider meeting with the District Principal Auditor (DPA) to discuss your disagreement with the audit.

The DPA is actually relatively helpful in resolving issues or clarifying the CDTFA's position on them.

Afterward, you will have a follow-up meeting with the CDTFA representative and make your presentation once again. At this point in the process, if you and the CDTFA continue to disagree about the audit and the case remains unresolved, the CDTFA will issue a **Notice of Determination**, and you may enter the Appeals process.

Appeals Process and Settlement

Once the Notice of Determination has been issued, you have 30 days to file a **Petition for Redetermination** using Form CDTFA-416. You may, instead, file your own petition but it must contain the following elements:

- ▶ It must be in writing
- ▶ Identification of the amount or amounts you are contesting

- ▶ Statement of the specific grounds or reasons you believe the tax is not owed
- ▶ Your signature as the taxpayer or the signature of your authorized representative

If you prefer, you can also request an oral hearing in front of the CDTFA. You may also request an appeals conference where you can present your case. At this point, you have the option to make a **Settlement Review Request** using Form CDTFA-393.

If you are not proposing a settlement and the case remains unresolved, there is a final step you can take.

Judicial Proceedings

You must go to court and attempt to prove your case. However, at this point, you are required to pay the proposed tax in full, although you will not be asked to pay any interest at this point.

The request for a judicial proceeding is a request for the court to review your information and the results of the audit. If the court finds in your favor, you will be refunded the tax you paid. If not, you will now be asked to pay the interest and any penalties as well.



CONCLUSION

Going through a CDTFA sales tax audit is nobody's idea of a good time, but they happen. My goal in this chapter was to explain how the audit process works and how to best prepare for it and hopefully, you were able to ascertain that it is a drawn-out complicated ordeal.

The good news is that if you disagree with the auditor's final report, you have many channels of appeal. Just keep in mind that the slow wheels of justice extend to the state level and the CDTFA is no exception. You

will have to wait for many months (years depending on how far up the judicial ladder you climb) for a final decision.

If you are facing a sales tax audit or are approaching the appeals process, I urge you to call me. This is definitely not an undertaking you want to try on your own. I have the expertise to advise you on the best course action and will help you prepare. You have a lot to lose if you try to fight the CDTFA on your own. Why not have the support of a skilled team who has your back?



06 How to File a California Sales Tax Audit Appeal

INTRODUCTION

So, you have survived the ordeal of a sales tax audit. You get the auditor's final report and do a double-take. You owe HOW MUCH? How did this happen? Before you beat yourself up or worse, call up your CFO or CPA and chew them out, just take a moment. Every taxpayer has the right to appeal the decision of the California Department of Tax and Fee Administration (CDTFA).

The process for appealing a CDTFA sales tax audit begins at the exit conference after the auditor has finished their investigation. If the audit report cites potential underpayment of taxes, fees or additional amounts you owe and you disagree, you will generally be given a time period to collect evidence and make your case.

Your next step is to meet with the CDTFA supervisor and then the District Principal Auditor. If you do not convince them that the results are in error, you can file an appeal.

The CDTFA appeals process is lengthy, so you will have several opportunities to prove that you do not owe the assessed liability. If your appeal is denied at every level, you can eventually appeal to the courts, although California law requires that you must pay the assessed tax (minus interest) before you can file.

If the court finds in your favor, then you can request a refund. Of course, the best way to appeal a sales tax audit is to not get yourself in that situation in the first place. If you are facing a sales tax audit or fear you might be a prime candidate for one, give me a call. I have successfully defended clients in sales tax audits for many years and understand the audit and appeals process. I seriously urge you not to attempt the appeals process on your own. There is too much at stake.



How to File an Appeal With the California Department of Tax and Fee Administration

Step One: Petition for Redetermination

You receive a **Notice of Determination**, which is a notification that the CDTFA has determined you owe more taxes than you paid. If you want to file a **Petition for Redetermination**, the first step of the appeals process, you must wait until this notice is issued. You have 30 days from the mailing date.

If you file a petition before the Notice of Determination is issued or beyond 30 days after it is mailed, your petition will not be considered valid. The liability will be considered final, due, and payable.

The Filing Must:

- ▶ Be in writing
- ▶ Identify the amounts you wish to contest: all or part
- ▶ State specific grounds or reasons why you believe you do not owe taxes or fees
- ▶ Be signed by you or your authorized representative
- ▶ Be mailed to the correct address

If you wish you can include requests for:

- ▶ An appeals conference by the Appeals Division

- ▶ A hearing before the members of the CDFA (an appeals conference must be held first)
- ▶ Your case to be considered under the CDTFA's Administrative Settlement Program, which is confidential and will not impact your appeal rights

What Happens Next?

The CDTFA reviews your position. At this time, it may ask for additional records or documentation to support your position. You may amend the petition with additional grounds for disputing the original determination as long as it is before the date the CDTFA makes its final decision.

Once the CDTFA notifies you of its conclusions, most petitions are resolved at this point. However, you may still wish to appeal if the CDFA staff denies your petition in whole or in part. You must confirm, in writing, your previous request for an Appeals Conference or a Department hearing.

If you have not already requested an appeals conference or have missed the deadline for responding to the Department's conclusions, a Notice of Redetermination will be issued to you with the staff's conclusion.

Step Two: The Appeals Conference

If you are continuing with the appeals process, you will receive a Verification of Appeals Conference Form, which must be completed and returned within 15 days.

The Appeals Conference is typically held in the CDTFA field office that prepared your audit unless you request otherwise. Once you



are there, you may record the conference at your own expense, either electronically or by a court reporter, but you must provide a copy to the Appeals Division at no cost if it requests one. The CDTFA does not record these proceedings.

Your conference will be with an Appeals Division attorney or auditor who has had no prior involvement in your case. You will receive a **Notice of Appeals Conference** from the Case Management Section with the date, time and location. You must return the Response to Notice of Conference Form within 15 days to confirm your attendance.

You may waive attendance if you wish, and submit written arguments and documentary evidence in support of your appeal before or during the conference. If you want to do so after the conference, you will need the permission of the Appeals Division.

After the conference, the Appeals Division mails you a **Decision and Recommendation** based on all relevant arguments and evidence. The document contains an analysis, conclusion and recommendation for the resolution of your case. A letter will be included explaining the status of your appeal and any options you may have for further action.

If you agree with the Decision and Recommendation, the appeal ends, and the CDTFA will issue a **Notice of Redetermination** or **Statement of Account** based on the decision and recommendation from the Appeals Division.

If, however, you do not agree, you may be granted a hearing if you request one in writing within 30 days of the Appeals Division's letter.

The Consequences of an Audit Gone Wrong

California has over 800 laws and regulations included in the Sales and Use Tax legislation, all with supporting documentation. There are also two guidebooks with 24 chapters between them and a list of around 110 sales and use tax-related statutes.

Let that sink in.

Just the thought of receiving a notice for a sales and tax audit can make you feel like David getting ready to meet Goliath.

If you attempt to represent yourself in an audit and make a single misstep at any stage, things can go south very fast. Once you lose control of the audit process and are left with the deficiency, serious consequences can start stacking up:

- ▶ Additional taxes. The determination made by the auditor may be much higher than you anticipated.
- ▶ Seller's permit revocation. The CDTFA has the power to take away your seller's permit if they determine that you are delinquent. It is a crime to continue to sell without a permit, so this can effectively shut down your business overnight.
- ▶ Other license revocation. Thanks to a recent bill, the broad powers of the CDTFA allow them to revoke or suspend the professional permits and licenses of severely delinquent taxpayers, including their contractor, medical or driving licenses.



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- ▶ Information sharing with other governmental bodies. The CDTFA will send an audit report to the state income tax body, the California Franchise Tax Board (FTB), which then reports to the IRS. This can lead to cascading tax audits from several agencies at once.

CONCLUSION

If you come out on the wrong end of a sales tax audit, please call me. The team at Brotman Law know the ins and outs of how the CDTFA operates and can best advise you and represent you in an appeal. We also know California tax laws at the back of our hands and can set you on the right course to win your appeal. The average taxpayer simply does not have the knowledge and expertise to try to represent themselves in an appeal. You need to focus on what *you* excel at, which is running your business.

There is just too much risk involved in going up against the CDTFA if you are not sure what you are doing. Put your trust in Brotman Law and have the peace of mind that we have your best interests at heart and will work hard on your behalf. I also advise you to get together with us to develop a sales tax compliance plan so that as you move forward, you will not have to worry about the CDFTA knocking on your door ever again.



07 Should I Hire a California Sales Tax Lawyer to Help Me with My Sales Tax Audit?

INTRODUCTION

While dealing with the fallout of a California Department of Tax and Fee Administration (CDTFA) sales tax audit is rarely pleasant, it is possible to mitigate the effect on your business, if you have the right help.

When you confront an audit on your own, you are dealing with the complexities of the system for the first time and navigating your way through this process without a map.

Hiring a qualified tax attorney is like choosing an experienced guide to lead you through a hazardous landscape. They know the territory like the back of their hand and can steer you away from pitfalls and back onto solid ground.

My firm, Brotman Law, has a proven track record in successfully defending our clients in sales tax audits. These are complicated engagements with many moving parts, which would be overwhelming for the average

business owner/taxpayer. While it may seem noble to go it your own, it is really not the best approach.

In this chapter, I am going to discuss the qualifications and benefits of working with a tax attorney and surprisingly, why you should not turn to your CPA for assistance in a sales tax audit.

The Benefits of Working With a Tax Attorney

Tax attorneys offer in-depth knowledge of state and federal tax codes as well as having solid legal training. That is the type of “one-two punch” that you need when dealing with the CDTFA.

Here’s what you can expect from your tax attorney:



- ▶ True qualifications. A law degree, admission to the state bar and subsequent education in the specifics of tax law have uniquely equipped your attorney for all the complexities of a CDTFA audit.
 - ▶ Confidentiality. Unlike conversations with your bookkeeper or accountant, everything you discuss with your attorney is protected under attorney/client privilege. You can be completely frank and open in your meetings, which will allow your attorney to advise you with greater clarity.
 - ▶ Thorough knowledge of California tax law and understanding of CDTFA procedures. They understand the many intricacies of the law and are able to analyze complicated tax information with a clear and practiced eye. Unlike the auditor, who only knows the audit procedure, your attorney can look ahead to the appeals process, which gives you a strategic edge in negotiations. Please note that California sales and use tax law is a particularly complex area and it is best to hire a specialist or someone with a broad understanding of CDTFA audit procedure.
 - ▶ Complete understanding of state court rules and procedures. If your case ends up in court, your attorney knows the rules of evidence and all the other requirements and processes of court cases.
 - ▶ A barrier between you and stressful encounters with tax authority agents. Once you have hired an attorney, the tax agents are required to deal with the attorney and not with you. For most clients, this is an incredible relief — no more stressful phone calls or meetings to cope with. You can relax, knowing your case is in good hands.
 - ▶ A tireless advocate. Tax issues can be extremely isolating, and it is terrible to feel alone when you are confronting a huge government agency. Your attorney is unconditionally on your side, every step of the way. They can negotiate for you in meetings and CDFA appearances, help you towards a settlement, or stand up for you in court. They will walk you through the audit and appeals to get you out of trouble and allow you to get on with your life.
- If you have been selected for a sales tax audit, you can probably remember in excruciating detail the exact moment you opened that envelope. Chances are you are still reeling.
- While receiving a sales tax audit proposal from the CDTFA is a serious matter for any business, it is not reason to panic. The best thing that you can do is stay calm and contact a qualified tax attorney. With the right representation by your side you can find a clear path through this process and come out the other side with your business and your sanity intact.



Why a CPA Isn't Your Best Defense

The biggest problem that I see with most sales tax audits stems from the lack of proper control at the beginning of the audit. We encounter this problem a lot in our practice, so I will highlight this as an example. When people get notice that they are being audited for sales tax, the tendency is to take the notice and they give it to their CPA to deal with.

The CPA is focused on this from a compliance perspective. They call the auditor and they ask, "What do you want?" and the auditor replies, "I want the documents that were issued on that notice."

The CPA gathers up three years of sales records and three years of purchase records on all the internal financials and the bank statements, and then they hand it over to the auditor. Then the auditor takes that information, they go off by themselves, and then they come back and they have a \$100,000 bill, and then the CPA freaks out and the client freaks out. So the audit is done, and then somebody calls us and we get involved.

Most clients and most CPAs think about this from the angle of, "We will just produce the documents that the auditor asked for. We did not do anything wrong. We do not have anything to worry about. There should not be any harm in just turning over the documents. Why get an attorney involved?"

The answer to that is even if you have not done anything wrong, there is always the potential for risk in a sales tax audit because of the way things are calculated. So an attorney's job in the sales tax audit is

not just to hand over documents and push paper. The attorney should be, number one, controlling the scope of the audit.

They should be controlling both the documents that are being requested and the methods that the audit is being conducted under, and then the attorney is there to help move the process along.

The attorney will move the auditor through the analysis, supervise the analysis, make sure things are being done correctly, make sure the auditor is relying on the most accurate method of testing available, whether that is looking at source documents or conducting proper statistical tests, and then going from there.

So having an attorney who has a knowledge of audit procedure involved early in the process, sets the tone for the entire audit.

It is so much easier to deal with things at the beginning and do them properly than to go back and try and correct things. It is more of an exercise, and time, and effort, and money to get that done when a lot of it could have been filtered out at the beginning.

If you take control of the process at the beginning, control the documents and everything about the audit, you are going to end up with a much better result. That is why it is really important to get an attorney involved early in these audits versus later on.

Sales Tax Audit Defense Strategies from Brotman Law

Sales tax audits are notoriously tricky. They consume a lot of resources, both in time,



and energy and money. The goal with us and with our clients is to get out of the process as quickly as possible for the least amount of damage.

When we look at a CDTFA audit, we are looking at the cost-benefit of the situation. What is the cost to the client, what is the benefit of a certain action, and how best can we get out of the audit with minimizing our expenditure and being as efficient as possible with our resources?

One of the best ways that we do this is prior to creating the audit plan, we will try and pre-audit the client.

Pre-auditing the client is very important because it gives us a roadmap for how the sales tax audit is going to go and what the areas of risk are for the client. Once we have had the benefit of pre-auditing the client, we can develop a plan for the audit with the auditor. We can navigate the client through the least amount of risk possible with our agreed-upon plan.

This is the best way to approach a sales tax audit. In the meantime, while we are going

through the audit process, an eye needs to be kept on the appeals process in case the audit goes south. Disagreements with the auditor can and do happen quite frequently. Even the best well-made plan sometimes will fall apart.

Therefore, it is important for our firm to stuff the record as much as possible with things that are going to be beneficial to the client. To the extent we have control over the preliminary audit report, that gives us a better avenue going into appeals in advancing the ultimate resolution in the case.

Ideally, we want to try and avoid the appeals process, if possible, or use it as a means to get the liability down further after a successful audit. But, depending on the auditor, depending on the methods of testing used, and depending on the size of the fight that we have to engage in, sometimes, that is not always possible.

Whenever possible, we try to minimize expenditure, conserve resources and fight for the best possible outcome for the client.

CONCLUSION

My hope is that having read this chapter, you are convinced of the need to have knowledgeable skilled representation when facing a CDTFA sales tax audit. As with any transaction, there is always room for negotiation and trying to face this alone can be a huge mistake resulting in far more costly tax liabilities and penalties than you were looking down the barrel at going in.

Whether you engage Brotman Law or not, I wanted to educate you on why you need professional guidance in a sales tax audit and why your CPA is not your best option. I have nothing against CPAs but they cannot offer some of the assurances that an attorney can.

If you are facing a sales tax audit or need more information, I invite you to call me and schedule a consultation. If you have an hour to spare, spend it with Brotman Law.



08 How the California Sales Tax Audit Defense Practice Works with Brotman Law

INTRODUCTION

Sales tax audits are one of the areas of practice that I am most proud of at our firm. We have dealt with some very difficult cases and gotten some really phenomenal results. I credit that to the hard work and diligence of our team. Brotman Law really understands sales tax audits.

We understand the tax law surrounding why sales are taxable and why they are not taxable. We understand the tax procedure in terms of understanding the interactions with the auditor, their manager, and the district principal auditor, and then through the appeals process, and up through the Office of Tax Appeals.

Finally, we understand statistical sampling which is a very rare quality in attorneys. Most attorneys do not have a strong knowledge of statistics. It is not something that they teach you in law school. Statistical sampling

and being able to sustain a data fight in the context of a sales tax audit is a very admirable quality.

We want to be on not only equal footing with the auditor, but we want to have the superior advantage during the entire audit because in our experience that is the way you get results for the client.

That is why you can trust Brotman Law to stand by your side during a sales tax audit. If you are facing an audit or want to be proactive in not becoming a prime candidate, keep reading. I explain our strategies and explain the basis for our fee structure.

Our Strategy

We use a very measured approach. We measure twice and we cut once, but our methods are strategic. They are designed to make the process as least burdensome for our clients as possible. They are designed



to move them through the sales tax audit process quickly and with as little exposure as necessary. We are very good at what we do in the course of sales tax audits.

We fight. We have a strategic tenacity and we do the best we can to leverage our efforts to get you the best result. I encourage you to sit down with us and give us the facts. Let us look at your documents and let us start formulating a strategic plan. Whether or not you ultimately choose to retain us, at least take advantage of the benefit of our knowledge so that we can look at your facts and guide you specifically through your situation.

Sales tax audits have the potential for a great amount of risk for people going through them. Even clients who make the mistake in thinking that because they have not done anything wrong they do not have any risk in an audit. The good news is that with our help, strategic planning and expertise with the execution process, you can minimize your liability as much as possible.

What to Expect Cost-wise

As I have mentioned before, sales tax audits are very cumbersome processes. They involve a lot of documents and a lot of data and they take a while to get through. At our firm, efficiency is one of our key factors in the work that we do. We want to make sure that the work and the value that we are providing for clients are in line with their cost expectations.

With that said, sales tax audits are a lot of work. There is a lot of organization and presentation of the materials. There is a lot of tendency for disagreements in sales tax

audits particularly when the auditor is using statistical samples.

Oftentimes, those statistical samples come out wrong on the CDFA side and we have to correct them. It gets tough when you have an auditor and you get into a conflict with that auditor and the auditor will have to back down because we have proved them to be in the wrong.

With that said, sales tax audits have the ability to drive cost. One of the things that we do to mitigate cost is by trying to minimize cost in three key areas. The first one is with decisions.

We would like to put our clients in the position to make quick and accurate decisions. The easier decisions come, the easier it is to deal with the sales tax audits and the lower the cost to the client.

Number two is documents. We work with the client and our team to streamline the document gathering, organization and presentation process. A lot of times, we can put the burden on the client and the client has internal resources to handle document organization and delivery much more efficiently than our staff or at least at a lower cost.

If that is not the case, we have a very talented team of junior staff members who have done a lot of sales tax audits and who can work through the process very quickly, assembling exactly what our senior team is going to need to defend the audit.

The third avenue is bureaucracy. Unfortunately, with most agencies, bureaucracy goes hand-in-hand. Occasionally, you are going to have good



people in the CDFA, who are going to move the audit through quickly and without hassle but also occasionally, you are going to have some bad people.

Most CDFA auditors will fall within the middle but the goal, at least at our end, is to organize the audit to come to terms with the auditor at the beginning and to agree on an audit plan to move the audit forward as efficiently as possible. With those caveats said, what I tell clients is sales tax audits usually range between \$5,000-\$15,000.

Obviously, that is a pretty big range but it depends on the client, it depends on the amount of data that we are dealing with and it depends on the difficulty that we are having with the auditor. Rest assured, we are going to try and minimize the cost in the process.

We certainly are cognizant of the fact that a sales tax audit is a marathon and not a sprint and we want to save and allocate resources for when we are actually going to need them. We also want no illusions coming in about how big the process is and how much risk it is to you if it does not get completed properly.

That is the best estimate that I can give you about the cost of your matter. If you want to know more, the best way for me to give you a cost projection is by understanding the facts about your particular situation. When I can apply your facts to the situation at hand, I can give you a much better estimate of what the cost would be in your particular matter.

CONCLUSION

Whether you hire Brotman Law or not, I want to offer one piece of advice that you should not ignore. It is foolhardy, to put it kindly, to try to defend yourself in a sales tax audit. The average taxpayer simply does not have the in-depth knowledge of tax laws as an experienced professional does. Also, going up against the CDFA can be a stressful and intimidating process if you do not understand how they operate.

Your simple lack of knowledge will place you at a distinct disadvantage and the CDFA will

“smell the fear” and take advantage of it. You could actually end up in a worse situation than you were at the onset.

I am not trying to scare you into hiring an attorney, just stating the obvious. As you have read, Brotman Law has been defending sales tax audits for years and our fees are based on the complexity of the situation and how well the client has maintained records. If you are on the fence, I invite you to contact me for a consultation. The most it will cost is an hour of your time. Why not?



09 What Is Use Tax in California?

INTRODUCTION

An overview of use tax bears repeating because it can create so many headaches and it is an area where the California Department of Tax and Fee Administration (CDTFA) is really digging in its heels. In fact, use tax is one of the most miscalculated and unpaid taxes found during audits.

Use tax is a tax on the use of tangible personal property not otherwise subject to sales tax. Use tax is typically owed when someone purchases a product while paying less than the applicable sales tax or paying no sales tax at all.

Unless that buyer has an exemption, use tax is owed to the government. Use tax is also due when a product is purchased from outside the state for use within the state when the seller is not registered for, nor collects sales tax in that state.

Use tax is a tricky one to sort out because it can easily get overlooked or overshadowed by sales tax. But, make no mistake, the

CDTFA is equally as diligent in its pursuit of unpaid use tax as it is of sales tax. So ... buyer beware ... literally.

In reality, there are few businesses that do not purchase goods to be resold to the end-user. If that situation describes you, then it behooves you to call me for a consultation. I can take a look at your records and determine if there are transactions subject to use tax. Keep reading to learn the difference between sales and use tax and what the CDTFA will look for during a use tax audit.

Use Tax: Background

Use tax in the past has not been the purview of the seller; the buyer owes the use tax. However, state governments are beginning to hold sellers responsible for it when it is not paid.

What to Do:

- ▶ Learn the difference between sales tax and use tax



- ▶ Write a use tax policy for your business
- ▶ Review all your non-resale purchase invoices and determine consumer use tax where is applicable
- ▶ Properly track and account for any withdrawals made from your resale inventory

Use tax is a counterpoint to sales tax. For example, if I buy a car in Arizona, I can ship it to California because California is not charging me sales tax on that transaction because it is not occurring within the state. Instead, they charge me a use tax.

Use tax is levied on consumers of merchandise used, consumed or stored in California. It does not matter where it was purchased. If you buy something from an online source that is not registered to collect California sales tax or else does not collect it, you are on the hook for paying the tax, which is the same rate as the sales tax.

Use tax is also imposed on leased merchandise such as cars, boats and planes. If you make a purchase in a foreign country and hand-carry it through U.S. customs into California, you must pay the use tax.

Use tax is the tax that a merchant pays for importing goods into California. In situations where there is no sales tax, the merchant pays use tax.

Sales and use taxes are mutually exclusive. You cannot be required to pay both sales tax and use tax for the same merchandise.

Special Issues in California Use Tax Audits

Tax Auditor Treatment of Use Tax on Leases

In general, during California use tax audits, use tax will only be assessed 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 will be made to determine if any tax liability exists.

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 CDTFA-1164) will be prepared and sent to the lessor's district. During use tax audits, the auditor will not assess 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 the property being leased is not mobile transportation equipment (MTE). If tax is assessed, Form CDTFA-1164 will be sent to the lessor's current district showing the amount of tax assessed and the applicable periods.

Use of Form CDTFA-1164 by the Tax Auditor

In California use tax audits, taxpayers should be careful with resale certificates from the purchaser, because the auditor will pay attention to the nature of the goods to determine if a transaction was conducted in bad faith.



For example, if a jewelry store obtains janitorial equipment and obtains certificates, the auditor will review this transaction very carefully and may determine lack of good faith by the taxpayer, leading to serious consequences.

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 generally will not be determined against the purchaser unless the sale occurred outside of California or is otherwise a transaction subject to use tax.

Form CDTFA-1164 will be prepared by the auditor setting forth the pertinent facts about the transaction. This form, along with any supporting documents, will be used as the basis for investigation in California use tax audits.

The auditor will also prepare Form CDTFA-1164 if they find that the seller did not charge tax and has accepted a properly executed resale or exemption certificate in good faith. The auditor can question whether the buyer has in fact purchased the merchandise for resale or if an exemption applies.

The auditor should also prepare Form CDTFA-1164 where it is determined that a vendor is improperly computing tax on its invoices.

For example:

- ▶ Is not 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 migrants which are discovered during audits of California sellers will be disallowed against the seller. The auditor also will prepare Form CDTFA-1164 for such sales, which then will be forwarded to San Diego District Office.

Treatment of Storage of Property Intended for Resale in Use Tax Audits

If a purchaser presents a resale certificate or purchases property for the purpose of reselling, stores or uses the property for purposes other than retention, demonstration or display while holding it for sale in the regular course of business, then use tax based on the purchase price will accrue from the date the property was first stored or used.

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:

1. 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.



-
2. During California use tax audits, 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.

CONCLUSION

You simply cannot ignore use tax and know that just collecting sales tax is sometimes not enough. There is a marked difference between the two, and as a California business owner, you must understand this.

The CDTFA is serious about cracking down on unreported and uncollected use tax, so it would be a smart move to set up a compliance system for your business. This

is where we can help. Brotman Law has a solid reputation for helping small businesses stay out of hot water with the CDTFA by developing and implementing sales and use tax compliance plans.

If you are confused about sales and use tax or have received notice from the CDTFA, give me a call and we can develop a game plan to correct your situation.



10 Your Rights as a California Taxpayer

INTRODUCTION

If the California Department of Tax and Fee Administration (CDTFA) has decided that you owe taxes, just know that you are not alone. Dealing with the state can be an intimidating and frustrating process, but the first thing I recommend is to clear your head and remember that as a California taxpayer, you have certain rights, which I will discuss in more detail in this chapter.

The CDTFA administers the tax program for both business and property taxes for the State of California. Business taxes include:

- ▶ Sales and use tax
- ▶ Fuel tax
- ▶ Cigarette tax
- ▶ Alcoholic beverage tax

Business taxpayers may take up their concerns directly with the main office of the CDTFA while property tax concerns are addressed by the local county office.

When you deal with the tax agencies of California, you may feel like you do not have any rights. These agencies can come across as aggressive and overwhelming to most individuals who are not used to dealing with them.

However, you do have rights, an important detail to remember any time the CDTFA contacts you. Below is an overview of your rights as a taxpayer engaging with the California Department of Tax and Fee Administration.

When you are up against the CDTFA, it is important to have a skilled and trusted partner at your side. That is why you can call me if you are facing your “15 minutes of fame” with the state. (Well, actually, it takes much longer, but the experience is equally intense and not in a good way.)

I have represented numerous clients before the CDTFA and put their mind at ease as we went through each step of the process. Let me do the same for you.



Your Rights During a Sales Tax Audit

Sales and use tax audits are stressful, and some agents do not go out of their way to help you feel calmer. Remembering and exercising your rights during a tax audit can reduce the tension.

During an audit, you have a right to:

- ▶ An impartial and fair examination
- ▶ A clear explanation of the audit process and the reason for any information requested
- ▶ Bring in an accountant, attorney, or other representative to assist you at any point during the audit or an appeal
- ▶ Appeal audit findings
- ▶ Reimbursement for reasonable appeal fees and expenses if the CDTFA staff action was unreasonable

A business tax audit covers the tax returns you have filed in the past three years. If for some reason, you have not filed returns for that period, the law allows the CDFA auditor to look back eight years.

Your Rights During the Appeal of a Sales Tax Audit

If you decide to appeal the audit findings, you have 30 days from the date of the Notice of Determination, which is the document you receive with the audit findings. During that time, interest on your tax liability will continue to accrue.

The CDTFA recommends paying the tax portion in full as soon as possible to stop the accrual of interest. Any amounts not due will be refunded with interest at the conclusion of the appeal.

If you miss the deadline to appeal, you will be required to pay your tax liability in full and file a Petition for Redetermination, a claim for refund in order to dispute the amount you owe.

To be awarded full appeal rights, the petition must:

- ▶ Be made in writing
- ▶ State why you disagree
- ▶ Include any facts to support your claim
- ▶ Request a hearing

You must respond to all correspondence during the appeal or risk denial of your claim.

The formal appeals process includes an independent review of your case by the CDTFA's legal department. Several courses of action will be evaluated as a viable resolution.

You have some rights you may exercise regarding the appeals conference:

- ▶ Right to a conference held at the CDTFA office most convenient to you
- ▶ Right to receive prior notice if the conference will be recorded
- ▶ Right to receive a copy of the recording

If your appeal is denied, you are required to pay the liability in full before you can pursue an appeal in a court of law.



Your Rights During the CDTFA Collection Process

You are legally obligated to report and pay taxes and fees when they are due. If you fail to pay on time and do not respond to their attempts to contact you, **the CDTFA can and will attempt to collect the debt, including resorting to such means as:**

- ▶ Filing a lien against your property
- ▶ Placing a levy on your wages, bank account and personal property

To avoid missing any correspondence from the CDTFA or any other taxing agency, you must be diligent about updating each agency with your current address and information about changes in business ownership.

During the collection process you have the following rights:

- ▶ To be treated courteously and professionally by the CDTFA employees
- ▶ To tax clearance to protect yourself from the responsibility for tax debts of your business seller
- ▶ To be notified 30 days prior to a lien filing
- ▶ To free release if the lien is filed in error
- ▶ To request a hearing with the staff in a local CDTFA office if you feel a levy is excessive
- ▶ To file a claim for reimbursement of bank charges and third-party check fees created by the levy if your bank account is seized

- ▶ To be notified 60 days before the CDTFA revokes or suspends your seller's permit or business license
- ▶ To ask the CDTFA to relieve certain penalties if you can show reasonable circumstances that caused you to incur them

You also have a right to an Offer in Compromise if all of the following are true:

- ▶ The tax or fee liability is on a closed account
- ▶ You are no longer associated with the business that incurred the liability
- ▶ You do not dispute the amount you owe
- ▶ You are unable to pay the full amount in a reasonable time

There is one circumstance where your right to be notified 30 days prior to the filing of a lien is not upheld and that is when you have received a jeopardy determination.

Your Rights to a Jeopardy Determination Hearing and for Claiming a Refund

A jeopardy determination is a tax bill for immediate payment of the liability. You have several rights regarding this type of tax bill

You have the right to:

- ▶ Establish the jeopardy determination is for an amount not owed, is excessive, or should be delayed



- ▶ Request an administrative hearing before a representative of the CDTFA's Appeals Division to determine if the sale of property seized by the CDTFA would result in irreparable harm to you

You also have the right to claim a refund for payments you made that may have exceeded what you owe. You have to exercise this right within three years of the due date of the return for which the overpayment occurred or six months from the date of the actual overpayment, whichever is later. The jeopardy determination must be in writing, stating the basis for your claim.

Other Taxpayer Rights

You have the right to confidentiality and the right to know why you are being asked for information. You have the right to be told how the CDTFA will use any information you provide as well as any penalties or other actions that could occur if you do not respond.

As always, you have the right to prompt, courteous service and fair treatment free from harassment and inappropriate conduct. The following may not be considered in regards to your rights or the conduct of policies:

- ▶ Race
- ▶ Color
- ▶ Religion
- ▶ National origin
- ▶ Ancestry
- ▶ Sex
- ▶ Disability

You can obtain copies of your account records from the CDTFA via email or postal mail. You can also receive them directly from the CDFA office that administers your account.

CONCLUSION

If the tax man cometh, remember... you have rights throughout any process you may go through with the CDTFA. Also, you always have a right to an attorney to help you through the maze of tax laws and to stand compassionately by your side at any time.

Oftentimes, the CDFTA is banking on taxpayers being unaware of their rights and the many of more acerbic agents will play on your fears. Please! Do not put up with these

intimidation games. Stand your ground and the best way to do that is to know your rights.

Two minds are always better than one and that is why I encourage you to contact me if you need support. Together, we can plan a strategy and present a united front against whatever weak sauce the CDTFA is trying to serve you.



11

What Is Sampling and Testing in a Sales Tax Audit?

INTRODUCTION

Facing a California Department of Tax and Fee Administration (CDTFA) sales tax audit can be daunting, especially if your business is in a high-risk industry, such as a bar or restaurant. The auditor will need to go through your transactions to find any under-reported sales tax.

Well, if your business is successful at all, you will have thousands and thousands of transactions over a three-year period. The CDTFA is not going to pay an audit team to sort through all of that data, so they are going to make a SWAG (scientific wild a** guess) through sampling and testing.

A lot of the goals of the first meeting with the auditor are to go through the process and try to keep the auditor on pace. Very early in the audit, the auditor has to make a decision on the method of testing that they are going to use. In most situations, you want them to stick to the direct method of testing.

The auditor is either going to do the direct method of testing, which is based on those primary source documents, or they are going to use an indirect method of testing, which is a statistical sample.

The decision of whether the auditor is going to use the direct method or indirect method of testing can make or break your audit. Depending on which method they use, the auditor will run their test and will draft a preliminary audit report.

After that preliminary audit report gets drafted, the auditor and the representative will work to clarify any discrepancies and then they will produce a final audit report.

If the taxpayer agrees with the audit report, the audit is over. If the taxpayer disagrees with the audit report, they can appeal it.

When you are audited, you need to have the auditor use the direct method of testing if at all possible. Leaving the outcome to the whim of the auditor and their sampling leaves



you wide open to errors and judgments that are excessive of what you may truly owe the state.

Brotman Law's strategy in defending sales tax audits is for the client to maintain the upper hand in the audit. In other words, we control the information flow to the auditor, not the other way around. That is why it is in your best interest to be represented by a professional California tax attorney when facing a CDTFA sales tax audit.

Direct Method of Testing in California Sales Tax Audits

The **direct method** of testing is looking at source documents in the course of an audit and making sure that everything matches. That is the preferential way of dealing with sales tax audits because it is the most reliable; it is based on actual data and not statistical guessing.

To illustrate the direct method of testing, take a restaurant, for example. What a direct method testing would involve for a restaurant is looking at the bank statements for a given year, sales tax returns that were filed in that given year, 1099-Ks, merchant account processing statements for credit cards, internal accounting that was done during that year, and then the POS system reports.

You take those five or six pieces of data and you compare them across each other to make sure everything lines up. For example, one of the most frequent errors that we see in sales tax audits with people who are under-reporting their sales tax is their federal income tax returns and their sales tax returns do not match.

To the extent possible, and particularly when the client has not done anything wrong, we want to keep everything to a direct method of testing. If the direct method of testing holds up and the auditor's unable to challenge it, then there is no real reason to go towards any statistical analysis.

The quickest and easiest way to wrap up an audit is to say, "Here are six pieces of paper that prove I do not have any sales tax liability," and going from there. The problems arise when you find discrepancies in those audits and then you have to move to an indirect method of testing.

Indirect Method of Testing in California Sales Tax Audits

The direct method of testing is very straightforward and involves testing actual source documents, lining them up and comparing them. When you have a breakdown in the direct method, then sales tax auditors will resort to what they call **indirect methods** of testing.

Indirect methods of testing is a fancy way of saying, "we are going to play guessing games with statistics." One of the indirect methods of testing is to audit past sales. The auditor will look at current sales and they will perform statistical comparisons between past sales and current sales.

The problem with statistics is you are taking a population of transactions and then you are taking a sample of that population.

For example, say I have a restaurant and the restaurant had three years of sales that are included in the sales tax audit. Depending on which days I pick for my sample, it could



significantly skew the results of the audit. If I pick weekdays, I am probably going to see a lower transaction amount, and I am probably going to see more cash sales.

On weekends where there are more large groups and more people go out to dinner, and there are larger transactions, I might see fewer cash transactions. I might see larger than average daily sales.

Two weekdays versus two weekends, if taken as a sample and applied to that population, could yield very different results from a statistical standpoint. Even if the restaurant is diligent enough to track its daily sales, if I am using a statistical method to arrive at those sales, versus what the restaurant has, I could get a huge discrepancy.

Observation Testing

One of the easiest tests the auditors run is through an **observation test**. The CDTFA will send an auditor into a business for a couple of days to look at the sales transactions, whether the employees are ringing everything up correctly and whether they are charging tax.

Then, the auditor will sit there and literally record every single transaction, and they will compare that against the POS system reports to see if there are any discrepancies. That is the observation test. If there is an error within that test, then they will perform certain actions based on that error.

The other thing they can do is they can take the POS system reports in a current period and look at the cash to credit card ratio. A lot of the time, they will take your credit card ratio, which can be verified by your 1099-

Ks and say, “Okay, here is the percentage of credit card sales based on current. Here is the amount of cash sales and we are just going to project that across the quarter.”

The problem that we see with indirect methods of testing, taking the cash to credit card ratio, for example, the auditor comes in and says, “I am going to do two days of testing in a business. I am going to come in on Tuesday at lunchtime and I am going to come in Sunday afternoon.”

What the auditor is saying is that two days of testing are going to be used as a sample. They are going to take that sample and they are going to apply it to a population, with the population being a total dataset.

They are going to take a two-day sample and they are going to apply it to a three-year period of a population.

The three-year population is over 1,000 days. The auditor is going to take two days of sales, and they are going to say, “These two days of sales — Tuesday at lunchtime and Sunday afternoon — are representative of this entire 1,000 days of sales.” Hopefully, you can see the problems with that.

Some businesses do more credit card sales on the weekends and some businesses are seasonal and will have more frequent sales at certain times than others. With restaurants, families go out for dinner on Saturday nights and those tend to be larger checks. Larger checks tend to be paid by credit cards.

Little hinges swing big doors, and this is why indirect methods of testing are so dangerous. These little statistical changes can have a huge impact on the liability.



One of the reasons I advocate for having someone represent you in a sales tax audit who understands statistics, is because of these situations. We find so many statistical errors.

The auditors are not statisticians, so we find many errors in the way that they are doing their statistical analysis, the tightness of their controls, their procedures and the way they are applying samples to populations.

Whenever possible, you want to avoid indirect methods of testing and focus on direct methods because direct methods of testing are much more reliable than their indirect brethren.

Different Types of Statistical Testing in California Sales Tax Audits

Audit Based on Verification or Accumulation of Taxable Differences

Auditors may decide to use verification of taxable differences rather than base the audit on total sales and claimed deduction basis. This method is preferred when records are available, but the verification of gross receipts or deductions is unnecessary due to the low number of transactions.

It may also be used when the taxpayer reported taxable measure is based on a listing of transactions, the capitalization of tax reimbursements, or by markup of taxable purchases.

A comparison between recorded and gross sales can disclose a number of discrepancies:

- ▶ Sales, gross receipts, fuel use
- ▶ A month in which a department or branch was not included in reported totals
- ▶ Classes of transactions or use that are erroneously considered non-taxable by the taxpayer

Audit Verification Methods

The accuracy of lists and tapes of taxable items is verified by determining if you failed to tax any items that should have been taxed and by verifying that all the items you charged tax on were indeed taxable. Postings and computations are verified as well.

Auditors check your math on:

- ▶ Any taxes charged on customer invoices
- ▶ The posting of tax charges to a sales journal,
- ▶ Clerical accuracy of footings and posting of tax charges to a tax accrual account
- ▶ Your tax charge conversions to taxable measures.

Auditors employ several types of tests and sampling during a sales tax audit. The degree of complexity ranges from very simple (direct testing) to increasingly complex statistical sampling. There are also industry-



specific tests, such as a **markup test** or **pour test**, which are frequently used in retail settings, restaurants and bars.

Taxable Measure Basis

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 auditor will verify that all sources of revenue and deductions have been examined.

Taxable measure basis may be preferable for the CDTFA in a number of cases. For example, when records are available, but verification of total gross receipts and deductions is not necessary because taxable transactions are few in number and the taxpayer has reported taxable measures only based on a listing of these transactions, capitalizing tax reimbursement, or by markup of taxable purchases.

Another circumstance is where the total gross reported is not an important factor in determining taxable measure. For example, this is the case with service enterprises, contractors, public utilities, manufacturers and wholesalers (applicable for sales tax purposes).

Other cases include circumstances when direct audit of records will not yield results for the CDTFA and indirect audit is necessary, or where the taxpayer has prepared returns on a taxable sales basis and audit time can be conserved by conforming to this method.

For example, where a grocer has used a method other than the “grocers method” to

arrive at the taxable measure or the overall markup, as reflected by recorded gross sales, is unfavorable, the audit might be conducted in a more efficient manner through a verification of taxable sales.

The CDTFA makes a comparison between recorded and reported total gross an important procedure, 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.

Through this comparison the CDTFA may discover classes of transactions or use erroneously considered nontaxable by the taxpayer.

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

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

If the taxpayer reported on a basis of the tax actually charged to the customer and has credited that amount, the clerical accuracy of the posting to that account, as well as the computations made in converting the tax accrued to taxable is measured by the following tests:

- ▶ 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

For example, debits to the accrual account will be scrutinized by the CDTFA to determine that these charges represent proper deductions from the amount of tax accrued.

In addition, the auditor will 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. A reconciliation of the tax accrual account and the tax reported will be made by the CDTFA auditor.

Consideration also will be given to sales and use taxes collected for and paid to other states. Deductions claimed or netted will be tested by the auditor to ensure they are allowable.

CONCLUSION

If you had not seen a dentist in three years and finally went in for a checkup, should the dentist base their diagnosis on your three-year-old x-rays? Of course not! Then, do not let the CDTFA do the same to you in a sales tax audit. For better or worse, your business will have undergone changes in the past.

That is why you should never allow an auditor to base their conclusions on a random sampling of transactions that occurred in the past. The CDTFA conducts sampling

and testing to save time, so they really do not get an accurate picture of your business operations.

If you want the best possible outcome from your sales tax audit, then please call me. My firm, Brotman Law, has successfully defended sales tax audits for our clients for many years (more than three!) Put our experience to work for you. We will control the flow of information in the audit, so you can be certain that the auditor will be basing their findings on relevant transactions and not relying on old data.



12 Types of Testing Used in Sales Tax Audits

INTRODUCTION

From the California Department of Tax and Fee Administration's (CDTFA) viewpoint, when it comes to sales tax audits, time is money. That is why they need to take shortcuts when it comes to auditing a high volume business. There is no way the state can afford the time to have one of their auditors comb through every single transaction that occurred over a three-year (or whatever interval) period

That is why the auditor will use short tests and sampling to narrow down the process. There are a variety of methods, which I describe in this chapter. In a nutshell, the auditor is going to take a "snapshot" of your business' transactions, then extrapolate that to ultimately determine if you are copacetic with your sales tax reporting.

I do not agree with sampling and testing because there are just too many variables to consider. If the auditor made the wrong assumptions, then you could be on this hook for a greater sales tax liability than warranted.

If you are facing a sales tax audit, then I urge you to get in touch with me. With careful planning, we can devise a strategy to control the audit and reduce the number of transactions that the auditor can look back at. It is definitely worth your time to meet with me.

Short Tests

The CDTFA uses **short tests** to come up with a decision as to whether to proceed or to accept as correct that item being tested. In fact, the CDTFA encourages its auditors to use short tests when a taxpayer's records are in order. However, at any time, a short test can be expanded into full 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 markup over cost is acceptable for the type of business, a spot check of sales invoices for proper tax accrual, etc.

The nature of the short test places a great deal of emphasis on the individual auditor's judgment. The auditor evaluates the results of a short test and comes to a decision as to what to do.

In certain businesses where the number of transactions is large (e.g., department stores), the CDTFA auditor may 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 versus spot checking, would be construed as a short test because this forms the basis of a decision to stop testing or to proceed. If the auditor decides to proceed, this original test might be the nucleus of an expanded audit program.

Size of test period. Auditors 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

There are two broad categories of testing used in sales and use tax auditing – **statistical sampling** and **block sampling**. The second category of testing is used when statistical sampling cannot be used.

The auditor will examine any record, supporting data, or other information to determine whether or not to proceed with the audit on that document or if it can be accepted as correct without further examination or investigation.

A short test can be expanded into a full examination any time but saves time when a full examination is clearly not required to establish accuracy. In some instances, a short test is designed as a control test of documents over a short period to determine the most representative sample size for audit.

Testing is split into two categories: **statistical** and **block sampling**. Block sampling is used when statistical sampling is not possible. The auditor also looks into the conditions for employing the tests, especially when looking at the consistency of units sold or in business characteristics during the test period.

The size of the test period depends on what it takes to provide reasonable accuracy without excessive effort in comparison to the problem. Test periods are usually complete months or quarters. If daily or weekly controls are established, periods shorter than one month may be selected.

If your business has excellent controls, the test period will probably be a very small sample of the audit period.

The CDTFA looks for a number of conditions to employ tests – most important of which is consistency of units sold, consistency in business characteristics in the test period and so on.

For example, 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. Verification is then made by the auditor in accordance with the taxpayer's method of computing the claimed deductions.

In general, when auditing a business with good internal controls, 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 controls, the test period most likely will cover a larger proportion of the audit period.

If records are available, the periods selected for testing will 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 consist of complete months or quarters, but periods of less than one month may be selected by the auditor if daily or weekly controls can be established.

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

The CDTFA checks for errors and statistically applies them to the general number of transactions. If errors are irregular and non-recurring, the CDTFA will eliminate them from the test and be excluded from the calculations of a percentage of error. For example, any sale that is rare or out-of-the-ordinary, can be considered, for classification, as nonrecurring.

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 will be requested to prepare supporting schedules for the test periods only.

The proposed measure resulting from the projection of the sample results will be compared and analyzed for reasonableness by looking at the taxpayer's business as a whole. If the results appear unreasonable, the auditor will discuss the situation with the taxpayer. The auditor and the taxpayer will need to come to some kind of agreement as to whether or not the results are representative of the business for the time period in question.

The auditor will, 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. In fact, very often during the audit, the auditor will discuss and consult with the taxpayer about the audit's procedures and techniques, to ascertain necessary information.

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.

The auditor and taxpayer will work together to obtain missing documents or the auditor can ask for additional documents that may indirectly provide information sought by the auditor.



The auditor will develop a sampling plan to outline methods of testing, the timeframe and so on. 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 operations for the period under audit.

This examination includes a review of source documents, changes in business activity, and changes in accounting procedures and key personnel. A plan is usually completed with assistance and input from the taxpayer. The information and methods documented in this plan are not binding on either the taxpayer or CDTFA staff.

The sampling plan can and will 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 are fully explained and discussed with the taxpayer.

CDTFA staff must first try to obtain any data or documents which should have been retained in accordance with Revenue and Taxation Code Section 7053 from the taxpayer. However, if all other available avenues of information have been exhausted and approval of the district administrator has been obtained, CDTFA 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 must comply with the California Right to Financial Privacy Act.

CDTFA Audits: Prior Audit Percentages of Error (PAPE) Program and Cut-Off Techniques

The ***Prior Audit Percentages of Error (PAPE)*** 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. It can be a valuable tool in streamlining the audit process and is designed to reduce the time it takes to complete an audit and minimize the burden on taxpayers.

When planning the audit, CDTFA supervisors and auditors evaluate whether the taxpayer is eligible for the use of a PAPE. This evaluation is conducted whether or not the taxpayer has already requested the use of a PAPE. If the taxpayer is eligible for the use of a PAPE, the auditor discusses the PAPE with the taxpayer as soon as possible rather than wait for the taxpayer to request it.

To qualify for the PAPE, the taxpayer must have at least one prior audit and must meet the number of conditions. One of the conditions is consistency of business operations during prior audit and current audit. Minor changes are generally ignored. It is important to remember that the use of a PAPE is limited to the current audit period as a PAPE cannot be used in two subsequent audits.

The CDTFA also uses ***cut-off techniques***. "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.

It could be used for the whole examination or for a specific task or test and the auditor has discretion in this case. When a prospective cut-off point is reached, a decision is made by the auditor whether to accept the test results, alter the audit approach, or discontinue the audit.

Basically, an important consideration here is given to the existence of errors. It is up to the auditor to decide if errors exist, whether to keep testing or disregard errors. The auditor can decide to accept test results and the cut-off point is reached then. The auditor considers materiality of error, frequency of error, and other factors.

The principle of whole dollar auditing (i.e., dropping cents) is used by the CDTFA as 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. In this case, any \$.49 cents and below are rounded down, and \$.50 cents and more are rounded up.

A whole dollar audit is not used when the taxpayer objects (the auditor may still try to convince the taxpayer by explaining this method), when computing markup form shelf orders or when precise data is necessary.

During an audit, the auditor will examine multiple records to find undisclosed and unreported taxable transactions. The general ledger accounts will be examined for debits and credits. The auditor may examine general journal entries, correspondence, contracts, sales or revenue invoices, cash

receipts records, accounts receivable ledger, partners' drawing accounts and employees' advance accounts, purchase journal for sales at cost or returned merchandise, including inventory accounts.

The auditor will try to reconcile sales or revenue reported to general ledger. In cases of missing or flawed records, the CDTFA auditor will do gross profit and net worth analysis. The auditor will review tax returns as well.

Overall, the CDTFA auditor will make a significant effort to ensure a good relationship with the taxpayer and will try to make the audit convenient for the taxpayer, as long as the taxpayer does not create unnecessary obstacles for an audit. Nevertheless, it is advisable for the taxpayer to cooperate with the auditor to ensure a smooth and efficient auditing process. It is also really helpful to ensure that all books and records are always kept in order, even if the taxpayer does not expect an audit

Markup Tests

When the CDTFA cannot verify through direct audit, it will perform a **markup audit**. A markup is the amount added to the cost of a good or service to obtain sales tax from the buyer. It is a percentage of the gross profits divided by the cost of goods sold.

A markup audit is often used to prove materially misstated or fraudulent accounting, especially for cash-intensive businesses. Auditors are trained to spot illegal programs that periodically make a certain amount of sales and cost of goods disappear from a point of sale system (POS) while simultaneously informing an owner how much



cash to skim illegally from the POS to make things even.

Auditors will also approach a vendor to compare whether the dollar amount of goods sold to the business under audit matches what the business's cost of goods sold account for the same period.

However, in the context of a sales audit, a markup test is kind of what it sounds like. It determines the markup in the aggregate of taxable products that are being sold.

Take a restaurant, for example, the auditor will look at all the menu items, and they will have somebody break out food costs and say, "Okay, if you are selling burritos, tell me all the ingredients that go into the burrito and give me an estimate of how much it cost you to make that, and then let us see what your markup is."

Markup tests are really dangerous because markup tests generally vary across different products.

A restaurant selling beer can have a certain markup. A restaurant that is serving shots coming out of a bottle is going to have a higher markup on liquor than with beer. In trying to take an average of those two things, it is really difficult to get an appropriate average markup.

We try to avoid markup tests whenever possible. If we have to go through them, we will try to limit the scope of the markup test to make it as easy as possible on the client and to make sure that the results that we are getting are really consistent

Markup tests are very common, particularly in retail settings, with restaurants, and with a variety of other businesses. They really should be avoided at all costs.

CONCLUSION

When you are embroiled in a CDTFA sales tax audit, you need all the advantages you can get. When the auditor is shooting craps with your data, the odds are pretty good that the results will not come out favorably with you and that is the way it works with sampling.

Why take the chance? If you want to play the odds, then take a weekend to Vegas. When it comes to your business, it is not worth it. That is why I invite you to contact me if you received a notice from the CDTFA that your business has been selected for a sales tax audit. Our firm has seen it all before and we know what to do. We will take control of the audit to eliminate the guesswork and get you the most honest, accurate results possible.



13 California Sales for Resale and Resale Audits

INTRODUCTION

There are few retailers who wholly produce all goods that they sell; the majority purchase their products from other sellers, such as manufacturers, for resale. That process is perfectly legit, but where retailers get into trouble is when they need to prove to the California Department of Tax and Fee Administration (CDTFA) that items were purchased for resale.

I can not stress strongly enough that you maintain all resale certificates and any other documentation that supports that the goods you purchased were for resale (e.g., purchase orders). If not, you are going to suffer some major pain points if you are summoned for a sales tax audit by the CDTFA. Just as one example, you may have to contact all of your customers to collect back sales tax. Talk about a PR nightmare.

Trust me, you do not want to be in that situation. That is why I invite you to get in touch with me if you have any questions

about your reseller status in California. We can review your transactions and if necessary, begin collecting the necessary paperwork.

In this chapter, I discuss requirements for resellers and more importantly, what can transpire during a CDTFA sales tax audit.

Requirements for Resellers

A claimed sale for resale will be allowed in a CDTFA audit if it is supported by a resale certificate from a person who sells tangible personal property and 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 California, an appropriate notation to that effect will be entered in lieu



of a seller's permit number on the resale certificate under Regulation 1667 governing exemption certificate requirements.

A certificate will be considered timely if it is submitted 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. CDTFA auditors can be stringent when enforcing the resale certificate requirement.

In an CDTFA audit, any document, such as a letter or purchase order, provided by the purchaser to the seller in a timely manner 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 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.

Resale Audits

One of the most common targets in a California sales tax audit is sales for resale. Sales for resale is the most common deduction claimed by California taxpayers and one of the most common targets of the CDTFA.

CDTFA sales tax auditors are especially careful in examining accounting methods

used by taxpayers and use various procedures to verify amounts. Often, California taxpayers will estimate this deduction and will get tripped up in a sales tax audit when the CDTFA auditor uses their verification procedures.

Normally, there are two ways that a CDTFA auditor will verify sales for resale. First, if the claimed deduction consists of relatively few items so that all transactions can be examined in a reasonable amount of time, the California sales tax auditor will audit every item in detail. Consequently, if sales for resale are numerous and of a reasonably similar unit value, the verification will be made on a test or sample basis.

The auditor will develop parameters for their test, such as a time period and a method for screening data. This test will then be imputed to the rest of the audit period.

California sales tax audits for sales for resale generally are broken down into three classification categories:

- ▶ Detailed audit — lists of claimed sales for resale available
- ▶ Detailed audit — lists of claimed sales for resale not available
- ▶ Audit on test basis

California Procedures for Detailed Sales Tax Audits Where Resale Data is Available

In the case of a detailed audit and when a list of claimed resales is available, claimed



resales will be summarized by months or by quarters in accordance with the taxpayer's listings and records. The taxpayer's detailed schedules will be used as a basis for the verification.

The auditor will examine sales invoices and other documentary evidence of the non-taxability of the sales, such as resale certificates, purchase orders, correspondence, or contracts. The nature of transactions and the type and number of items purchased will be scrutinized to determine whether resale certificates appear to have been taken in good faith.

All sales questioned by the auditor for any reason will be listed on a subsidiary schedule. A copy of this schedule will be given to the taxpayer as an aid in attempting to support the exempt status of the questioned items.

A reasonable period of time must be given to the taxpayer to obtain this information before closing the audit. If a list of claimed resales is not available, then the auditor will request the taxpayer to prepare a detailed listing of all claimed sales for resale and the taxpayer must be allowed a reasonable amount of time to do so.

If questioned resales are not supported by the taxpayer to the auditor's satisfaction during a California sales tax audit, then those sales will be disallowed.

One special item of note: sales to Mexican merchants for resale are allowable if certain requirements are met. For example, a Mexican Merchant Identification Card must be valid and not expired at the time of the sale and the merchandise purchased

for resale must be related to the special business classification codes on the card.

What Can be Considered a Resale Certificate in a CDTFA Audit

The CDTFA provides detailed guidelines for CDTFA audits about what can be considered as a resale certificate. The CDTFA provides the following examples:

1. A purchase order that contains all the elements of a valid resale certificate, containing words "for resale"
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"
3. 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. A seller must retain copies of the purchase orders



along with the qualified resale certificates in order to support sales for resale.

4. 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
5. Contracts of sale where all the essential elements of a resale certificate are included

Other evidence of the validity of a claimed sale for resale may be accepted in a CDTFA audit.

Use of Form CDTFA-504: Proving That a Sale was Not a Resale

In a CDTFA audit, taxpayers should keep in mind that any of the evidence other than the actual resale certificate, by itself, is not the equivalent of a resale certificate and may not relieve the seller of the liability for the tax.

In absence of any valid resale documentation, in a CDTFA audit, the auditor may determine that it is appropriate for a seller to use the Form CDTFA-504 series of forms (called “XYZ” Letters) procedure to help satisfy the 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 taxpayer’s customer paid the tax directly to the state.

When it is appropriate to use the “XYZ” Letter process, the auditor will provide the taxpayer with a copy of forms CDTFA-504-A, B and C,

or other type, if applicable. Various types of this letter are described on CDTFA’s website.

A response to an “XYZ” Letter inquiry alone is not necessarily enough to support a sale for resale. Generally, the “XYZ” Letter is not a substitute for a timely resale certificate, additional documentation or information may be required by the auditor.

CDTFA Audit: XYZ Letter Procedure

The CDTFA will allow the taxpayer four weeks 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 CDTFA. The auditor will provide the taxpayer with appropriate forms and return envelopes.

If the taxpayer elects to have the “XYZ” statements returned to them instead of the CDTFA, then the likelihood of having CDTFA staff contact the customer or sending an additional mailing is greater. Generally, in a CDTFA audit, you would not want the auditor contacting the taxpayer’s customers.

The taxpayer may customize the “XYZ” cover letter. However, the use of a standardized “XYZ” statement will reduce any possible controversy over whether the proof provided is satisfactory.

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 CDTFA.



All modifications to the cover letter must be approved by the auditor's supervisor. The "XYZ" statement must be used as provided by the auditor. The taxpayer's customer is requested to return the completed "XYZ" statement within 10 days. The CDTFA auditor may request a second XYZ letter to be sent, depending on circumstances.

All customers' responses are part of the audit working papers and will be used in the audit. When XYZ responses are not returned, the CDTFA audit staff will make every effort to determine the taxability of the questioned sale by alternative methods.

The auditor can examine the customer's seller's permit registration to determine whether or not the purchaser had a permit at the time of purchase, can review the quantity and type of items sold, review a subsequent resale certificate and can contact the customer over the phone.

Please note that the CDTFA auditor is allowed to accept or deny support contained in documents based on personal knowledge 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 another reason. In this situation only (but not in cases of corporate changes or reorganizations of customers) 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.

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 will be treated by the CDTFA auditor as an error.

CONCLUSION

A CDTFA resale audit is definitely something that you will not find on (m)any bucket lists. They are rough. The CDTFA is not messing around and will go to great lengths to collect all taxes it believes it is due. If you are facing a resale audit, then all me as soon as possible. I have successfully defended my clients in resale audits and can certainly help you.

As always, a good offense is the best defense. That is why I would advise you to work with us to devise a reseller strategy for your business. It is cumbersome, but will be well worth the time in the future. It is better to be proactive than to have to face the music with the CDTFA, which is not only time-consuming and expensive but can also be very detrimental and embarrassing to your business in the area of client relations.



14 Sales Tax Requirements for Retailers Outside of California

INTRODUCTION

If you are a retailer that is based outside of California, but derives revenue from California in the form of sales, leases, warehousing or other commercial activities, you must pay sales tax to California. That sounds like a mouthful and it is when trying to explain all of the nuances of what is considered taxable by California. Keep reading.

My firm, Brotman Law, specializes in small business taxation and we primarily work with California-based companies. However, if your business is outside California but you conduct significant business within the Golden State, it would behoove you to seek professional consultation regarding your sales tax status in California.

I wrote this chapter to help explain how the California Department of Tax and Fee Administration (CDTFA) defines a “retailer,” and this also applies to online transactions. In order to stay off the radar of the CDTFA, it is important that you understand where

you stand regarding your California sales tax responsibilities.

What is a “Retailer?”

An out-of-state retailer “engaged in business in this state” (California) is required to register, collect use tax on taxable sales made to consumers in California, and remit this tax to the California Department of Tax and Fee Administration (CDTFA).

Revenue and Taxation Code Section 6203 provides that (a) “retailer engaged in business in this state” specifically includes, but is not limited to, any of the following:

- ▶ Any retailer maintaining, occupying, or using, permanently or temporarily, directly or indirectly, or through a subsidiary, or agent, by whatever name called, an office, place of distribution, sales or sample floor or place, warehouse or storage place, or other place of business



- ▶ Any retailer having any representative, agent, salesperson, canvasser, independent contractor, or solicitor operating in this state under the authority of the retailer or its subsidiary for the purpose of selling, delivering, installing, assembling, or the taking of orders for any tangible personal property
- ▶ Any retailer deriving rentals from a lease of tangible personal property situated in this state

Clearly, maintaining an office space or having an agent in California can lead to tax liability to the CDTFA for an out-of-state retailer. Section 6203 does not stop here, and mandates the following: “Any retailer entering into an agreement or agreements under which a person or persons in this state, for a commission or other consideration, directly or indirectly refer potential purchasers of tangible personal property to the retailer, whether by an internet-based link or an internet website, or otherwise, provided that certain conditions are met.”

Other Types of Business

While I am not one to discourage interstate commerce, I do advise any retailers outside of California who do business in California to thoroughly understand their California sales tax obligations. The CDTFA is not shy about collecting sales tax and will aggressively

Entities

Consequently, if an out-of-state retailer, including an online retailer/store, has an agreement with a California agent/contractor/marketer/advertising agent/affiliate or anyone else who refers clients to retailer’s website, then the out-of-state retailer also must register with the CDTFA and collect use tax on taxable sales made to consumers in California.

Section 6203 also imposes such liability to the CDTFA in cases when the out-of-state retailer is simply a part of a larger corporate or holding group, where another member of that group is located in California and in agreement with the retailer, performs services in California to design and develop tangible personal property sold by retailer, or makes solicitation of sales of tangible personal property on behalf of retailer, or provides other services regarding tangible personal property to be sold by retailer.

Form [CDTFA-1164](#) is usually used by the auditor in the proper registration of out-of-state vendors who are engaged in business in California. A separate Form CDTFA-1164 is prepared for each vendor.

CONCLUSION

pursue any business they think is a profitable target. If you are in doubt of your status, give me a call. We can review your history of interstate transactions and determine if your California activities warrant paying sales tax.



15 What Types of Penalties Can I Face in a California Sales Tax Audit?

INTRODUCTION

If you owe sales tax to the California Department of Tax and Fee Administration (CDTFA), you need to be aware of the types of penalties they can assess and how much it will cost you.

The CDTFA declared that its policy is to encourage and assist all taxpayers in making an accurate and timely self-declaration of tax liability. However, they will impose penalties when justified by the acts or omissions of the taxpayer.

Whenever there is any doubt as to whether factual conditions justify a penalty for negligence or fraud, that doubt must be resolved in favor of the taxpayer. Negligence and fraud penalties are based on recommendations submitted to the CDTFA by field auditors and their supervisors based on facts they find during an audit.

The CDTFA cannot impose negligence and fraud penalties concurrently because they

are mutually exclusive. Only one or the other can be imposed at the same time. The same is true of the penalty for negligence and the penalty for failure to file a return.

However, for example, a fraud penalty and a 10 percent penalty for failure to file a return can be imposed in relation to the same amount of tax owed to the CDTFA.

Read this chapter to get a better idea of how the CDTFA operates in the area of sales tax audits and penalties to get a better idea of what to expect.

If you have been through a CDTFA sales tax audit and are confused about why you were penalized, give me a call. I have helped many small business owners get their penalties reassigned to a different category, which can oftentimes, reduce or completely erase the penalty.



Type of Penalties

Penalties are divided into two categories: mandatory or discretionary penalties. Both categories of penalties are imposed in accordance with provisions of the Revenue and Taxation Code (RTC). Mandatory penalties are imposed automatically, but the taxpayer may receive relief (cancellation or reduction).

Discretionary penalties can be assessed by auditors during audits. When there is a choice between discretionary or mandatory penalty, the CDTFA will usually apply the mandatory penalty. For example, the penalty for failure to file a return (mandatory penalty) rather than the negligence penalty (discretionary penalty) will be applied in those cases where either penalty could be applied.

The CDTFA provides examples of the following mandatory penalties:

- ▶ Failure to file a return – 10 percent under RTC 6511 and 6591
- ▶ Failure to pay taxes - 10 percent under RTC 6565 and 6591
- ▶ Failure to pay prepayment amounts - 6 percent under 6476 and 6477
- ▶ Amnesty interest penalty - 50 percent under RTC 7074(a) and Double amnesty penalty 7073
- ▶ Failure to pay prepayment amounts by suppliers and wholesalers of fuel - 10 percent under RTC 6480.4 The rate of penalty is increased to 25 percent if the supplier or wholesaler knowingly or intentionally fails to make a timely remittance of the prepayment amounts.

Discretionary payments include:

- ▶ Negligence or intentional disregard of the law or authorized rules and regulations (can be applied in a variety of circumstances) - 10 percent under RTC 6478 and 6484
- ▶ Fraud or intent to evade the law or authorized rules and regulations - 25 percent under RTC 6485 and 6514
- ▶ Improper use of a resale certificate for personal gain to evade the tax penalty can be imposed under RTC 6072 and 6094.5 (10 percent of the tax due or \$500 whichever is greater)
- ▶ Failure to remit sales tax reimbursement or use tax collected - 40 percent under RTC 6597
- ▶ Knowing failure to obtain a valid permit for the purpose of evading the payment of tax - 50 percent under RTC 7155
- ▶ Registration of a vehicle, vessel, or aircraft outside the State of California for the purpose of evading the payment of tax - 50 percent under RTC 6485.1 and 6514.1
- ▶ Failure to obtain evidence that the operator of catering truck holds a valid seller's permit - \$500 under RTC 6074
- ▶ Failure of a retail florist to obtain a permit before engaging in or conducting business as a seller - \$500 under RTC 6077



- ▶ Penalties are billed on a Notice of Determination sent by the CDTFA to the taxpayer and can be protested, or even canceled, if they are found to have been imposed by the CDTFA by mistake. Only the CDTFA can make a decision to impose or change any penalties. This means that auditors generally cannot impose penalties on their own.

Relief From Mandatory Penalties

The CDTFA is allowed to remove (cancel) mandatory penalties when a taxpayer fails to pay taxes or file a return for a good reason and because of circumstances beyond their control. However, the taxpayer must still be able to prove that they exercised diligence and did not simply neglect tax obligations.

Taxpayers who wish to request relief from penalties must do it after they receive a determination letter from the CDTFA. The taxpayer must present a request for relief in a written statement, under penalty of perjury, explaining the facts on which the request is based. The use of Form CDTFA-735, Request for Relief from Penalty (available at www.CDTFA.ca.gov), is recommended but not required.

After submission of the written statement by the taxpayer, the CDTFA will review and approve or deny the request. Any recommendation to approve or deny a request for relief above \$50,000 is usually forwarded to the CDTFA Deputy Director for additional review and then submitted to the CDTFA for consideration.

Even if a taxpayer's request for relief from penalty is denied, they can apply to the CDTFA for reconsideration of the negative decision. For penalties of \$50,000 or less, the CDTFA sends the taxpayer a denial letter, in which it usually explains that the decision to recommend denying relief from penalty can be reconsidered by the CDTFA if the taxpayer provides new information within 15 days of the denial letter.

The letter also explains that if the taxpayer provides additional information and the CDTFA staff still recommends to deny the taxpayer's request, the request for relief will then be reviewed by the Deputy Director. If the Deputy Director agrees with the recommendation to deny the request, the Deputy Director will send a letter to the taxpayer saying that they agree with the CDTFA's staff recommendation. Despite the established 15-day deadline, the CDTFA may still consider information received from the taxpayer after the 15-day period has expired.

Penalty for Failure to File a Return

The CDTFA can impose a penalty for failure to file a tax return. Every taxpayer with an active CDTFA account is required to file returns at regular intervals as required by the law and the CDTFA. RTC Section 6591 imposes a 10 percent penalty for failure to file a return on the amount of taxes due, with respect to the time period for which that return was required.

For example, if the taxpayer is on a monthly reporting basis and failed to file a return for only one month during a period under audit, a penalty would apply only to tax due for that month.



Failure to Pay Penalty

Revenue and Taxation Code Section 6591 imposes a 10 percent penalty for failure to pay tax on time, as follows:

1. To self-declared tax, when not paid on or before the due date of the return or before the expiration of any extension
2. To determinations made by the CDTFA, when not paid on or before the penalty date shown on the Notice of Determination, unless a timely petition (for redetermination) has been filed
3. To redeterminations, when not paid on or before the penalty date shown on the Notice of Redetermination

RTC Section 6565 imposes a 10 percent penalty for failure to pay the amount determined by the CDTFA if it is not paid before or on the date determination becomes final (30 days after service of the notice of

determination on taxpayer). However, this period is extended if the taxpayer files a petition for redetermination with the CDTFA.

RTC Section 6476 imposes a 6 percent penalty on the amount of a prepayment that is paid late, but which is paid before the last day of the month following the quarter in which that prepayment was due. If the failure to make the prepayment was because of negligence or intentional disregard of the Sales and Use Tax Law or other rules and regulations, RTC Section 6477 is increased by RTC Section 6478 to 10 percent instead of 6 percent.

The same 10 percent penalty applies under similar circumstances to any deficiency in prepayment. The penalties imposed in RTC Sections 6479.3 and 6591 apply to taxpayers who are required to pay taxes by means of Electronic Fund Transfer (EFT) but fail to do so. Prepayment penalties are not assessed in sales and use tax audits.

CONCLUSION

Failure to pay or file your sales tax on time can lead to penalties and these penalties can add up fast. This chapter explained the types of penalties and how they are assessed and hopefully, cleared up any confusion. If you have received a letter from the CDTFA stating that you owe them money, then call me. I can help you sort this out and hopefully, resolve the issue in a manner that will cost you as little as possible.

The best tactic is to avoid a sales tax audit in the first place. Having Brotman Law devise a sales tax compliance plan for your business will save you money in the long run. Having a system in place will give you peace of mind that you are playing by the CDTFA's rules and keep them off your back.



16 Negligence Penalties in California Sales Tax Audits

INTRODUCTION

The old saying, “ignorance of the law is no excuse,” is upheld tenfold by the California Department of Tax and Fee Administration (CDTFA) when conducting sales tax audits. The burden is placed on the taxpayer to prove their negligence when filing a return that does not quite pass the “smell test.” In other words, your records and your return tell drastically different stories.

You also cannot pass the blame off to your CPA or tax preparer. The CDTFA assumes that you, as an experienced business owner, are aware of sales and use tax obligations in the state and use knowledgeable professionals in providing tax advice and preparing returns.

In any case, the auditor will review all of your records and look for discrepancies in what is on your books versus what was reported on the returns. So, predictably, the larger the gap, the greater the penalty.

In this chapter, I will address what constitutes “negligence” in the eyes of the CDTFA for both recordkeeping and tax preparation. I will also explain the penalties and their amounts. If you are facing a sales tax audit and need advice, give me a call. We can dialogue about your situation and come up with some workable solutions.

What is “Negligence?”

Generally, a penalty of 10 penalty will be added if any part of the tax deficiency resulting from a taxpayer’s negligence or intentional disregard of the law. Negligence is defined in general as a failure to exercise due (proper) care, which means care that a reasonable and prudent person would exercise under similar circumstances.

According to the CDTFA, with respect to business tax matters, negligence may be further defined as a substantial breach by the taxpayer of some duty imposed by the law. CDTFA recognizes two major classes



of negligence: negligence in keeping records and negligence in preparing returns. These two types of negligence allow for the imposition of the negligence penalty.

In general, where an agent, employee, or partner of the taxpayer is guilty of negligence, with a resulting tax deficiency, the 10 percent penalty will also apply, even though the agent, employee, or partner acted without the taxpayer's knowledge or approval, or acted contrary to the express instructions of the taxpayer.

This applies even where the taxpayer has been defrauded by an agent, employee, or partner and as a result did not benefit from the understatement of tax. Application of penalties in this case is more likely if the taxpayer had opportunities to discover and stop the fraud but did not do so.

The negligence penalty can be applied only to deficiency determinations (when the CDTFA determines that the taxpayer still owes some amount in back taxes), and it applies to the total tax amount still owed.

Generally, this means that, if the penalty applies, it will be for the entire period of the audit regardless of class of transactions involved. In some cases, however, it would be improper for the CTFA to impose a penalty for the whole reporting period. For example, if a company changes management in the middle of the reporting period, it would be inappropriate to extend a penalty for the entire reporting period.

In such a case, the auditor usually prepares two forms, one for penalty imposed on one portion of the period, and another without penalty prepared for another portion of the

period where there was no negligence on the part of the new management.

Taxpayers can provide evidence to the auditor that may justify such a split of penalty period. The auditor will also check if subsequent management made an effort to eliminate negligence. If so, then penalty reduction is appropriate.

When a taxpayer is audited for the first time, the CDTFA advises its auditors that for such taxpayers, the negligence penalty is generally not recommended. In making that decision, the auditor should take into consideration the taxpayer's prior business experience, the nature and state of the records provided, and whether the taxpayer used an outside accountant or bookkeeper to compile and maintain the records, and/or to prepare the sales and use tax returns.

A penalty may be appropriate in any of the following circumstances: the taxpayer has no records of any kind, the taxpayer has a history of prior permits or business experience, analysis shows that purchases have exceeded reported sales, or the taxpayer has two sets of books. **The auditor's recommendation to impose a penalty is subject to CTFA review as follows:**

- ▶ Audit tax deficiency over \$25,000
— Reviewed and approved by the auditor's supervisor
- ▶ Audit tax deficiency over \$50,000
— Reviewed and approved by the District Principal Auditor subsequent to the review and approval by the auditor's supervisor



Negligence in Keeping Records

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

Such records that must be kept include:

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

Complete absence of records will constitute strong evidence of negligence. However, auditors must determine if there are mitigating circumstances for the lack of records. The term “records” as used by CDTFA includes not only those specifically mentioned in Regulation 1698, but also any supporting data as resale certificates, shipping documents in support of interstate transactions, etc.

The primary test for negligence used by CDTFA is whether a taxpayer keeps the type of records usually maintained by a

“reasonable and prudent businessperson” with a business of similar kind and size.

This means that the auditor will compare recordkeeping practices of the taxpayer with those generally used in the industry, with similar businesses or in the local geographical area. Taxpayers should note, however, that other similar taxpayers also can be negligent, and other taxpayers’ negligence cannot be used by them as an excuse, and penalties still can be imposed by the CDTFA.

If the evidence indicates that a taxpayer failed to keep proper records and, as a result, failed to compile tax returns with a reasonable degree of accuracy, and cannot substantiate the reported amounts when audited, negligence can be indicated by the auditor and the 10 percent penalty may be imposed.

Records need to be adequate only for sales and use tax purposes to meet the tax requirements of the type of business involved. For example, a large business will require a larger number of records due to a more complex accounting system.

Lack of knowledge of the requirements of the law is not a defense against penalties. However, the CDTFA asks its auditors to pay attention to such factors as the lack of formal education by a taxpayer. Generally, the more knowledgeable and experienced a taxpayer is — the higher the bar — as the benchmark is established for taxpayers in similar circumstances.

By the way, the taxpayer cannot be regarded as negligent merely because the records are kept in a foreign language. (See [CDTFA Penalties Manual](#))



Where records are adequate for sales and use tax purposes but contain errors that result in under-reporting of tax, the test for negligence is whether or not the taxpayer exercised proper care and diligence in keeping the records.

No matter how carefully records are prepared and checked, some errors may still occur. The auditor will consider the frequency and importance of errors, any difficulties inherent to the business that result in errors, and other factors.

Some of the factors considered by auditor are: number of errors comparative to number and dollar amount of transactions, the ratio of understatement of tax to reported amounts (larger amount of understated tax comparative to reported amount can indicate negligence), and the cause of errors (the cause of errors may result from procedural or operational problems unrelated to negligence. For example, a sharp change in sales volume resulting in staffing problems versus just negligence).

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

Taxpayers must keep records related to transactions for a minimum of four years, unless the CDTFA authorizes the taxpayer in writing that records can be destroyed sooner. Accidental destruction of records is not a negligence if the taxpayer properly

maintained and cared for records, and if the auditor is shown that records were really destroyed by accident.

Intentional destruction of records, however, may be viewed by the CDTFA as potential fraud or tax evasion. In case of intentional destruction of records, any tax deficiency will result in a 10 percent penalty if it stems from the destruction of tax records.

Negligence in Preparing Returns

The test for negligence in preparing returns is the same as the test for negligence in keeping records – whether proper care and diligence was exercised by the taxpayer. Mechanical errors in compiling returns do not mean there was negligence, unless there are too many of such errors.

Wrong application of the Sales and Use Tax Law when completing returns does not constitute negligence, unless the taxpayer failed to exercise proper care to check if transactions are subject to tax under law (failed to check with their accountant, for example).

Where there is doubt concerning the correct application of the tax, the taxpayer has a duty to make an inquiry. If the taxpayer fails to make an inquiry, the 10 percent penalty may apply. In general, if the taxpayer does make an inquiry and fails to act on the received information, the 10 percent penalty also may apply.

A taxpayer who was misinformed about the proper application of tax can be relieved from the payment of tax, interest and penalty if the



taxpayer meets the requirements for relief under RTC Section 6596. If a taxpayer was misinformed by CDFA staff, then a penalty generally should not be imposed, but the taxpayer is still liable for tax and interest.

The taxpayer must be able to prove that the CDFA staff misinformed them. The same standards which determine the application of the negligence penalty to tax deficiencies arising from an understatement of gross receipts or an overstatement of claimed deductions are used to determine the application of the negligence penalty to a

tax deficiency arising from failure to report purchases subject to use tax.

If the auditor finds that working papers used by the taxpayer in preparation of the tax returns have been destroyed and the taxpayer is unable to explain substantial deficiencies in reporting, the taxpayer must be given an opportunity to prepare new working papers or explain how amounts on the returns were derived. Failure or inability by the taxpayer to do so will usually constitute evidence of negligence and can justify the imposition of the 10 percent penalty.

CONCLUSION

Negligence can happen when preparing sales tax returns, but the CDTFA will not be quick to excuse it in the case of under-reported or delinquent sales tax. In most situations, the best you can hope for is getting out of it with a 10 percent penalty.

It is an expensive lesson, but one that is easy to not repeat. If you have come out

on the losing end of a sales tax audit or are facing one, I invite you to call me. I have successfully defended small business owners who truly were negligent in reporting their sales tax and faced the consequences. We can put together a strategy to prove your case and hopefully, knock back some of the penalties.



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What Are the Penalties for Tax Evasion and Tax Fraud in California Sales Tax Audits?

INTRODUCTION

If you are a merchant who thinks they can get away without paying sales tax, think again. The California Department of Tax and Fee Administration (CDTFA) is notorious for putting the screws to sellers who try to pull a fast one by not remitting sales and use tax. They have a lot of weapons at their disposal to find you ... and they will.

The one small glimmer of hope is that the CDTFA has to prove that your actions were deliberate acts of tax evasion or fraud, and that is very difficult on their end. That's why most of the CDTFA's cases are based on circumstantial evidence. And more often than not, they win. The resulting penalties are stiff.

The best strategy is to establish a sales and use tax compliance system in your business, so that you are not in a position where you feel that under-reporting or not reporting

your sales and use tax is your only option. In the long run, you will end up spending considerably more in penalties.

If you are in trouble with the CDTFA, I urge you to call me ASAP. I can review the circumstances of your case and prepare a defense. It will not be an easy undertaking but you have nothing to lose by trying.

CDTFA Penalty Structure

Generally, penalties for fraud or intent to evade are imposed only when tax deficiency determinations are made by the CDTFA. It is on the CDTFA to prove tax evasion before they can impose a penalty on the taxpayer.

The RTC sections that impose evasion penalties are as follows:

6094 RTC sections 6072 and 6094.5 — misuse of resale certificate to evade tax, 10 percent or \$500, whichever is greater.



- 6095 RTC section 6485** — fraud or intent to evade tax, 25 percent of determination.
- 6096 RTC sections 6485.1 and 6514.1** — registration of a vehicle, vessel, or aircraft outside of California for the purpose of evading tax, 50 percent of tax due.
- 6097 RTC section 6514** — fraud or intent to evade tax by failure to file return, 25 percent of tax, in addition to the mandatory RTC section 6511 failure to file penalty of 10 percent.
- 6098 RTC section 6597** — failure to remit sales tax reimbursement or use tax collected, 40 percent of amounts representing sales tax reimbursement or use tax collected and not timely remitted to the CDTFA.
- 6099 RTC section 7155** — failure to obtain valid permit by the due date of first return for the purpose of evading tax, 50 percent of tax due before permit obtained.

Fraud and Evasion

“Fraud” is defined as acts with intent to deprive the state of taxes due under the law. Intent to evade is intent to avoid paying tax through misrepresentation or deception. The CDTFA does not really distinguish between fraud and intent to evade, and refers to all resulting penalties as “evasion penalties” in either case.

Evasion is one step above negligence and occurs when a taxpayer acts beyond just failing to exercise proper care and diligence,

and if such failure was intentional and for the purpose of tax evasion. The CDTFA must prove such deliberate intent by so called “clear and convincing evidence.”

However, the standard of proof is not “beyond a reasonable doubt” as in a criminal prosecution (which is higher than clear and convincing evidence). (See [Helvering v. Mitchell](#) (1938) 303 U.S. 391). Instead, the standard of proof in civil tax fraud cases is “clear and convincing evidence” (In re [Renovizor’s Inc. v. CDTFA](#) (9th Cir. 2002) 282 F.3d 1233). “Clear and convincing evidence” requires evidence so clear as to leave no substantial doubt as to the truth of an evidence of fraud.

That is, there is a high probability that the assertion of fraud by the CDTFA has merit. The taxpayer’s intent is the key to imposing tax evasion penalties. Intent can be shown, for example, by consistent multiple tax under-reporting by the taxpayer.

If under-reporting is random, CDTFA will look at other factors, such as falsified records.

The amount of the discrepancy in relation to the tax reported is always taken into account. The higher the understatement of tax, the more CDTFA is inclined to consider that there was tax evasion.

Special Issues with Tax Fraud Penalties

In the majority of cases, the CDTFA relies on circumstantial evidence of tax evasion because direct evidence is very difficult to prove. The CDTFA uses the following factors in consideration of whether there was tax evasion:



1. Falsified records, especially when more than one set of records is maintained
2. Substantial discrepancies between recorded amounts and reported amounts which cannot be explained
3. Willful disregard of specific advice as to applicability of tax to certain transactions
4. Failure to follow the requirements of the law; claimed lack of knowledge of the requirements are refuted by permits or licences held by the taxpayer
5. Tax or tax reimbursement properly charged, indicating knowledge of the requirements of the law, but not reported
6. Transferring accumulated unreported tax from a tax accrual account to another income account

Auditors usually recommend the 25 percent penalty when a taxpayer's agent, partner, or employee has acted with intent to evade tax payment, even though the attempted evasion occurred without the taxpayer's knowledge or consent.

However, this penalty can not be recommended in the cases when an agent or employee defrauded the taxpayer, too.

It must be evidenced that the taxpayer also must benefit from acts of fraud or tax evasion before a penalty can be imposed. Generally, if a taxpayer has not benefited from the intent to evade, the evasion penalty should not apply.

If a tax evasion penalty is approved by the CDTFA, the agency must issue a memorandum describing in detail evidence to support the tax evasion penalty. Taxpayers should keep in mind that even if tax evasion was not discovered during the first audit, if it is present and discovered during subsequent audits, all previous periods, even those already audited, can be included by the CDTFA when it comes to assessing penalties for tax evasion.

Penalties for Misuse of a Resale Certificate and for Failure to Remit Tax

Revenue and Taxation Code (RTC) Section 6072 imposes a penalty of 10 percent or \$500, whichever is greater, for each transaction when a purchaser, for personal gain or to evade the payment of tax, knowingly issues a resale certificate while the person is not actively engaged in business as a seller.

RTC Section 6094.5 imposes the same penalty when the purchaser knowingly issues a resale certificate for personal gain or to evade the payment of tax, for the property which the purchaser knows at the time of the purchase will not be resold in the regular course of business. Various examples of when this penalty applies and does not apply are laid out in CDTFA of Equalization Penalty Manual which can be found here: <http://www.CDTFA.ca.gov/sutax/manuals/am-05.pdf>.

The penalty will apply in those cases where a pattern of intentional misuse of resale certificate is present, regardless of how large or small the amount involved. In those instances where a number of small



purchases from the same vendor are noted, a single, rather than multiple, penalty of \$500 or 10 percent (whichever is greater) generally will be imposed.

If the purchaser has been previously advised of the consequences of misusing a resale certificate, then possibly more than one penalty may be imposed. If the misuse involves large amounts with the intent of evading the tax, the 25 percent fraud penalty under RTC Section 6485 for intent to evade the tax will be considered by the CDTFA if the evidence exists to support the imposition of the penalty.

CDTFA auditors treat investigation of misuse of resale certificates as one of their priority assignments. In such cases, the auditor will always investigate the purchaser and will verify the seller's records. RTC Sections 6485.1 and 6514.1 provide a 50 percent penalty on a purchaser who registers a vehicle, vessel, or aircraft outside of California (i.e., in another state or foreign country) for the purpose of evading the tax.

The standards of proof for this penalty are similar to those for fraud in general. The penalty will generally be applicable when the purchaser is a California resident who purchased a vehicle, vessel, or aircraft for use in California and is unable to provide convincing evidence for registration out of state.

For reporting periods beginning January 1, 2007, RTC Section 6597 imposes a 40 percent penalty on any person who knowingly collects sales tax reimbursement (Regulation 1700, Reimbursement for Sales Tax 2) or knowingly collects use tax, and fails to remit the monies collected to the CDTFA in a timely manner.

The penalty is discretionary and may only be applied when all the conditions listed below are met:

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

In this case, the taxpayer has to explain to the CDTFA why the tax was not remitted and why it was not the taxpayer's fault. The CDTFA must disprove the taxpayer's explanation, or simply prove the taxpayer's fault with "clear and convincing" evidence.



CONCLUSION

The best way to avoid sales and use tax penalties is to keep yourself out of circumstances where you are not tempted to under-report to the CDTFA. It is much, much cheaper to collect and pay sales and use tax than to have to pay huge penalties to the state when you get called out by an auditor.

My firm, Brotman Law, has years of experience working with small businesses to implement a sales and use compliance plan. That is the best way to walk the straight and narrow and avoid problems with the state. If you have heard from the CDTFA about these matters, please call me to discuss what your options are.



18 What Is a California Sales Tax Exemption? [Definition + Examples]

INTRODUCTION

If you own a business which produces and sells tangible goods, then you are obligated to pay sales tax to the California Department of Tax and Fee Administration (CDTFA). There are, however, a number of exemptions to this rule, some of which apply to various types of goods and others which attach to certain buyers.

It is important to understand which types of business can get a partial or full sales tax exemption and the consequences for improperly failing to pay sales or use tax. Sales tax is a complex area of law, with a huge range of exemptions that apply to various goods or types of sellers.

Penalties for failing to pay sales tax are steep, so a little knowledge now can keep you from a huge liability later.

If you are not clear on your sales tax obligations, then keep reading. Also, you can call me and schedule a consultation. My firm, Brotman Law, specializes in working

with small businesses to ensure that they are compliant with all federal and state taxes. It is better to be prepared and aware of how sales tax works so you can prevent audits and other unpleasant surprises.

Exemptions and Exclusions From Sales and Use Taxes

There are a number of exemptions to the obligation to remit sales and use taxes. Some of these exemptions exist in an attempt to promote certain types of industry or consumer choices. An example is the current exemption on fresh, but not prepared, foodstuffs.

Other exemptions exist to avoid burdening certain organizations with the obligation to collect sales tax, and so many nonprofit or veterans' organizations are wholly exempt. Other exemptions are in place so that the same item does not give rise to two sales tax charges.



Thus, items purchased for resale, sold to various out-of-state entities (usually transport companies), or are in transit to an overseas destination, are exempt.

Other examples of exempt sales include sales of certain food plants and seeds, sales to the U.S. Government and sales of prescription medicine.

The list of exemptions is long and detailed, so if you are not sure if your business falls under those headings, you may wish to clarify with the [CDTFA](#).

In general, businesses which provide a service that does not result in a tangible good are exempt from sales tax, as it only applies to goods. For example a freelance writer or a tradesperson is not required to remit sales tax, although a carpenter making custom furniture is so required.

Online sellers who do not have sufficient sales nexus within California also do not have to collect sales tax, although the test for “sales nexus” is so wide that it will be considered sufficient if one of your affiliates, agents, warehouse suppliers or other place of business is located within the state. Presence at trade shows or conventions for more than 15 days in a calendar year will also establish nexus.

If you are selling to a customer who has an exempt status, you must collect a California Sales Tax Exemption certificate and keep it on file. If you are audited, you will be expected to produce this as proof that you sold an exempt item.

If you are a reseller, you may also apply for a California Resale Certificate, which allows you to buy goods within California for resale without paying sales tax on those goods.

Tax Exempt Items

There is a long and detailed list of items that are not taxable, but generally, the following are tax exempt:

- ▶ Food for human consumption
- ▶ Manufacturing machinery
- ▶ Raw materials for manufacturing
- ▶ Utilities and fuel used in manufacturing
- ▶ Medical devices and services

When looking at these broad categories, you can see the delineation between taxable and tax-exempt can be anything from the item in question being a human necessity, like food, to tax breaks provided to encourage certain industries to operate in the state. It seems like for each exemption or exclusion, there is an exception to the rule. Let us take a look.

A Closer Look at Tax Exempt Items

For a detailed list of tax-exempt items, the CDTFA issues a [Sales and Use Tax Publication](#) that shows the exemptions and exclusions to sales tax, some of which have expiration dates.

The CDTFA separates the items into broad categories:

- ▶ Necessities of life
- ▶ General public benefit
- ▶ Industry benefit



- ▶ Exclusions by definition
- ▶ Other exemptions, exclusions and credits

Food

As you may have guessed, the top necessity of life is food. However, the exemptions can appear complicated because the CDTFA looks at a variety of items that may not seem to be food but are related in a way that allows tax exemption.

For example, most food products for human consumption are easily recognized but where and how they are sold impacts the exemption. Food that falls under the following conditions is considered taxable:

- ▶ Sold in a heated condition
- ▶ Served as meals
- ▶ Consumed on or at a seller's facilities
- ▶ Is ordinarily sold for consumption on or near the seller's parking facility
- ▶ Is sold for consumption where there is an admission charge

However, there is an exception. Hot bakery items or hot beverages such as coffee sold for a separate price are still tax exempt.

The justification for the tax exemption on food products sold through a vending machine is just as convoluted. The vending machine operator is considered the consumer of any food products retailing for 15 cents or less and food products sold through bulk vending machines for 25 cents or less.

Wait, there is more: for sales of cold food products, hot coffee, hot tea and hot

chocolate through a vending machine for more than 15 cents, 67 percent of the receipts are tax exempt. The rest is fully taxed.

Other necessities of life include health-related products, services, and meals as well as some utilities like gas, water and electricity.

General Public Benefit

General public benefit tax-exemptions are conferred on alternate energy technology, museums and public art exhibits, certain aspects of non-profit, religious or educational organizations, and miscellaneous categories such as POW bracelets and pollution control facilities.

Non-profit organizations may only be tax-exempt if the profits from the items they sell go to benefit a specific group, such as AIDS/HIV patients or disabled children. Some exemptions even include language requiring the items to be made by the non-profit group.

Industry Benefit

Industry benefits in California obviously include the entertainment industry but also include transportation, petroleum, leasing, and manufactured houses and buildings, plus a raft of special classes like numismatic coins, custom computer programs and hay production.

Other exclusions and exemptions can be found on the list that includes details about sales prices and gross receipts, admission charges and other transactions not considered to be tangible personal property. There is even an exclusion for the term "person."



It seems there is no such thing as a simple tax. Sales and use taxes carry a plethora of legal definitions, exclusions, exemptions and exceptions within a group of exemptions.

It's enough to make a seller's head spin. However, it is unlikely a single seller will need to be cognizant of every category.

CONCLUSION

If you sell any goods in California, then you are on the hook for collecting sales tax from your customers and remitting it to the state. Failure to do so can mean big trouble with the CDTFA who has no shame about aggressively pursuing delinquent taxpayers.

They are not timid about using such tactics as direct seizure of your property or applying a lien against it.

Now in some instances, a business entity may be tax-exempt, which in that case, it is not liable for sales tax. In addition to this

chapter, there are other resources you can check to determine whether or not your business falls into the tax-exempt category.

If you are not certain whether you should collect sales or use tax, look at the [CDTFA website](#) or call me to discuss your situation. I have helped many clients determine their sales tax status, which prevented scrutiny from the CDTFA and future tax problems. Let me develop a sales tax compliance plan for your small business.

