Audit Manual

Chapter 4

GENERAL AUDIT PROCEDURES

Business Tax and Fee Division

California Department of
Tax and Fee Administration

Table of Contents

GENERAL AUDIT PROCEDURES 0400.00

INTRODUCTION 0401.00

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

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

AM sections 0401.00 and 0402.00 apply to audits, field billing orders and claims for refund. Completion of Form CDTFA-414-Z, *Assignment Activity History*, (CDTFA-414-Z) using the 414-Z Program is mandatory for all audit assignments (including reaudits and claims for refund). See AM section 0221.00.

Specific reference is made to the glossary contained in AM section 0490.00 for terms peculiar to tax auditing which are used in this chapter. The auditor is expected to have a good working knowledge of these terms prior to reading this chapter.

AUDIT SELECTION 0401.01

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

An audit assignment does not always result in a completed audit. Preliminary testing (AM section 0403.25) may disclose that an audit is not warranted, in which case auditors prepare Form CDTFA–596, *Report on Account Being Waived for Audit* (See AM section 0212.00).

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

- Are accurate and complete records kept?
- Does the markup on cost of goods sold appear adequate?
- Are the persons preparing tax returns familiar with the law and the rules and regulations pertaining to their particular business?
- Are the reported amounts reasonable considering the type of business, nature of the premises, the location in the community, etc.?
- Do the reported amounts vary materially from period to period?
- Is there a good system of internal control?
- Is the taxpayer's past reporting record good?

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

FORM CDTFA-1164 0401.02

The auditor should prepare Form CDTFA–1164, *Audit Memorandum of Possible Tax Liability*, (Exhibit 2) in appropriate circumstances. The information on this form is valuable in audit selection and may aid in disclosing tax that may otherwise remain unreported. Therefore, the importance of preparing this form cannot be overemphasized. For information on the use of Form CDTFA–1164, see AM section 0408.18.

The auditor should also be alert for activity in other tax and fee programs for which the taxpayer may not have a permit. See AM sections 0205.51, 0205.53, 0205.55, 0205.56, and 0205.57.

Confidentiality of Form CDTFA–1164 Information

Current policy allows copies of Form CDTFA–1164 to be released to a taxpayer if the confidential information about another taxpayer is redacted. Thus, seller information must be redacted when the form is provided to the buyer, and buyer information must be redacted when the form is provided to the seller. Any invoices that are attached to Form CDTFA–1164 must also be redacted to remove confidential information.

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

Audit Memorandums Concerning State Agencies

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

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

PUBLIC RELATIONS 0401.03

It is important that the auditor attempt to establish a good rapport with the taxpayer thereby encouraging a cooperative attitude. The Califonia Department of Tax and Fee Administration (CDTFA) has established a basic policy which is clearly stated in AM Chapter 1 — *General Information.* The complete compliance with this policy cannot be overemphasized.

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

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

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

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

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

MONEY LAUNDERING 0401.04

In cooperation with the Department of Justice, the CDTFA has agreed to provide assistance in the enforcement of money laundering violations by reporting suspected violations. If potential violations of money laundering or monetary instrument transaction reporting laws are suspected, a report documenting the suspected violation should be prepared and forwarded to the Deputy Director, Field Operations Department (FOD). FOD will then forward the report to the Department of Justice. This report should be submitted in a form similar to that shown in Exhibit 3.

The law contains two money laundering offenses the auditor should look for when conducting an audit. These are referred to as the "facilitation" offense and the "capturing" offense.

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

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

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

TAX AUDITING 0401.05

Introduction

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

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

Very limited testing or sampling may be all that is necessary to support a "No Change" report or "No Change" phase(s) of a "Change" report. Testing to support substantial change recommendations must include sufficient verification or explanatory comments so that the report is understandable and can be evaluated by other members of the staff as to the soundness of the auditor's opinion or recommendation. (See AM Chapter 2 for Form CDTFA–414–B, *Field Billing Order*, and field waivers (CDTFA–596) which are short of a full report as contemplated by Form CDTFA–414–C, *Report of Examination of Records*, or Form CDTFA–414–A, *Report of Field Audit*.)

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

Audit Approach

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

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

Approach to Auditing Credits or Refunds

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

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

The preferred method of sampling is statistical sampling, as described in Chapter 13 of this manual. Claims for refund using statistical sampling methods must meet the CDTFA's established standards for statistical sample evaluation. If statistical sampling is not feasible, non-statistical sampling procedures, as discussed in this chapter, may be considered.

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

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

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

Waiver of Credit Interest Policy

Claims for Refund

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

If the taxpayer has been granted a 90 day delay and requests additional time, consideration should be given to obtaining a waiver of credit interest. The CDTFA may require a claimant to sign a Form CDTFA–146, *Waiver of Credit Interest*, as a condition to deferring action on a claim for refund (Revenue and Taxation Code section 6908(b)). In some cases, it may be appropriate to allow up to an additional ninety days because of the size of the claim and quantity of supporting documentation required. However, delays beyond six months should not be allowed without a waiver of credit interest or the approval of the Deputy Director, Business Tax and Fee Department, or designee, or Deputy Director, Field Operations Department, or designee, as appropriate.

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

Deficiency Audits with Credits

If the taxpayer contends that there are other credits which offset or exceed a deficiency disclosed by an audit in process and requests additional time to obtain information supporting such credits, completion of the audit may be delayed for up to 90 days. A notation should be made on the CDTFA–414–Z of the date and reason for the delay. Should the taxpayer request a further delay, the deficiency audit should be completed as a non-concurred audit and processed in the usual manner.

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

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

Authorized Signatory

To preclude any question about the validity of a waiver, Form CDTFA–146, *Waiver of Credit Interest,* must be signed by:

- The owner in the case of a sole proprietorship,
- A partner in the case of a partnership,
- A corporate officer in the case of a corporation,
- A member in the case of a limited liability company (LLC), or
- A person holding a written power of attorney from the owner, partner, member, or a corporate officer.

Taxpayers may use Form CDTFA-392, *Power of Attorney*, to document power of attorney status. In lieu of Form CDTFA-392, CDTFA staff may accept any written documentation identified as a power of attorney containing the essential elements as described in AM section 0403.15, *Power of Attorney*.

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

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

A copy of the written power of attorney must be obtained and included with the copy of the waiver(s), Form CDTFA–146 in the ***Forms*** *subfolder of the audit case folder, and transmitted to Headquarters with the audit report if the waiver signatory is other than a corporate officer, partner or owner.*

Return Adjustments for Prior Overpayments

Taxpayers generally should not claim a deduction on a current return to adjust for an overpayment reported on a prior return. The correct procedure is to file a claim for refund for the overpayment. Nevertheless, under certain circumstances, a taxpayer may be entitled to claim a tax paid purchases resold, returned merchandise, or bad debt deduction in a later reporting period.

Only in very limited circumstances where a taxpayer makes an unintentional overpayment of prepayments on their tax return may the resulting credit be applied to a subsequent return. Only the Return Analysis Unit (RAU) and the Appeals and Data Analysis Branch (ADAB) are authorized to approve this procedure.

RTC section 6904 and equivalent special taxes and fees statutes require every claim for refund be in writing and state the specific grounds for the claim. RTC section 6905 and equivalent special taxes and fees statutes further provide that failure to file a timely claim for refund constitutes a waiver of any demand against the state for the overpayment. In a situation where a taxpayer erroneously overpays the CDTFA, a claim for refund must be filed with the CDTFA. This can be especially critical for taxpayers whose records are later audited. The following example illustrates the problems that can result from a taxpayer taking this kind of self-help deduction instead of filing a timely claim for refund.

> ABC Corporation (ABC) overpaid use tax on its third quarter 2012 return for a fixed asset purchase. The error was discovered in mid-2013. ABC reduced the taxable amount reported on its second quarter 2013 return by the overstated fixed asset purchase amount. ABC did not file a claim for refund.
>
> During a subsequent audit of ABC's records, the deduction claimed on the second quarter 2013 return was disallowed. The overpayment should have been claimed by ABC filing an amended third quarter 2012 return and timely filing a claim for refund. By the time the error was discovered, the statute of limitations for filing a timely claim for refund for the third quarter 2012 overpayment had expired, and the amount disallowed for the second quarter 2013 was correctly assessed in the audit. If the error is discovered past the statute date allowed for the claim for refund, the taxpayer has no further recourse.

OVERVIEW - AUDIT PROCEDURES 0401.06

To facilitate the completion of audit assignments pursuant to Regulation 1698.5, *Audit Procedures,* audit procedures and guidelines in AM sections 0401.07 to 0401.18 provide for the following:

- Appropriate and timely communication between CDTFA staff and the taxpayer, of requests, agreements, and expectations related to an audit.
- Auditing environment for timely completion of an audit within two years (neither CDTFA staff nor taxpayers should construe this goal to mean the audit must take two years when the audit can be completed sooner, or that the completion of an audit must occur within two years when a longer timeframe is warranted).
- Consistent definitions and procedures to allow audit manual users with various levels of expertise, both within and outside CDTFA, to navigate through the sometimes complex audit process.

AUDIT PLAN 0401.07

All audits must be guided by an organized plan. A carefully thought-out, but flexible, audit plan is the first step towards good working papers and a good start. Such an audit plan forces advance thinking and a proper overview of the assignment as a whole.

The objectives of the audit plan are as follows:

- Establish open lines of communication.
- Promote understanding of commitments made and agreements reached.
- Identify key potential audit issues.
- Assist in the progression and completion of the audit.

An audit plan allows the auditor and the taxpayer to work together to resolve problems as early as possible in the audit process and establish a common understanding and working relationship. The audit plan should be sufficiently detailed so that the taxpayer and CDTFA staff can assess, at any time, the extent of work that has been completed, the work remaining, and a timeframe for the completion of the work remaining. In doing so, the audit plan helps ensure an effective and efficient audit that is less burdensome, less costly, and less intrusive.

The complexity of the audit plan will differ based on the circumstances of each audit. The auditor should develop an audit plan that strives for the timely completion of an audit within a two-year timeframe beginning with the opening conference (AM section 0401.09) and ending with the exit conference (AM section 0401.16). Most audits, however, will be completed in a much shorter timeframe although some may require a period beyond two years. The auditor should consider the duration of the audit and anticipated completion date when preparing the audit plan.

Working With Taxpayers

A positive working relationship with the taxpayer is conducive to the effective and timely completion of the audit. Taxpayer participation in the development of the audit plan is encouraged. The audit plan should be discussed and expanded upon during the course of the audit as the auditor learns more about the taxpayer's business and records.

By reviewing the audit plan with the taxpayer:

- Both parties will be able to more efficiently manage the fact gathering and analysis process.
- The taxpayer will be able to anticipate deadlines better and provide alternative solutions to resolving issues, such as when specific records are unavailable or missing but alternative records or documents can be provided which contain the requested information.
- Apprehension by the taxpayer may be minimized, and communication and cooperation is enhanced.
- The materiality or immateriality of specific audit areas can be discussed early, and if appropriate, those areas found to be immaterial may be waived from examination.
- The audit plan can be revised as the need for more, less, or different work arises than originally noted.

Development of an Audit Plan

The audit plan sets forth the road map for the audit and therefore should be completed as a preliminary step to conducting the audit. Prior to the opening conference, auditors should begin to prepare an audit plan.

Because the audit process is collaborative, the auditor should obtain input and information from the taxpayer regarding the business and its records prior to the formulation of an audit plan. This may be done in a pre-audit conference (AM section 0401.08) or during preliminary contact to set-up the first audit appointment (AM section 0403.10).

In order for the audit plan to be meaningful and relevant, the auditor should review the taxpayer's history and prior audit(s) in determining the scope of the expected audit. This includes analyzing tax returns, transcripts, the taxpayer's account (including ownership); reviewing the prior audit history; researching the business and industry; researching for other CDTFA tax and fee accounts; and performing other information gathering techniques that provide the auditor with a better understanding of the taxpayer's business and potential audit issues.

The audit supervisor is required to review and sign the audit plan before it is presented to the taxpayer. The audit supervisor should document his or her approval on the CDTFA-414-Z (AM section 0221.00).

The auditor should discuss the audit plan with the taxpayer at the opening conference (AM section 0401.09), and provide a copy at the time of the discussion. When it is necessary for the auditor to first review the taxpayer's records or to obtain supervisory approval, a copy of the audit plan may be provided to the taxpayer after the discussion but no later than 30 days from the opening conference.

Additional guidelines for preparing an audit plan:

- The audit plan should be clearly marked "Initial" or "Revised" with a revision date at the top of all audit plans.
- After the opening conference, the auditor, the supervisor, and assigned team members (if applicable) should complete the final audit plan incorporating changes made as a result of discussions with the taxpayer.
- If there are significant changes to the audit plan discussed at the opening conference and the supervisor who previously signed the audit plan was not present at the opening conference, the auditor should submit the audit plan to the supervisor for review and approval before providing it to the taxpayer.
- Any changes or revisions to the audit plan should be provided to the taxpayer.
- Audit supervisors should review the progress of all audits at least monthly. The audit plan should always be a part of the review and the audit supervisor should write a comment on the CDTFA-414-Z at the time of review.

Audit Plan Details

In addition to any areas, audit procedures, and/or tasks to be addressed in the audit, the following items should also be included in the audit plan. Additions or deletions from the audit plan should be done on a case-by-case basis.

1. **Audit Scope** — The audit scope shows the audit period, district/branch/area office conducting the audit, areas to be examined, number of divisions or locations, related accounts, and overview of transactions.
2. **List of Key Personnel** — Identify all key CDTFA staff, taxpayer personnel, and any outside representatives, including their addresses and telephone numbers. The auditor should confirm that the taxpayer personnel identified in the audit plan are authorized to provide the CDTFA with records, receive Information Document Requests (IDRs), and are authorized to enter into preliminary and final discussions with CDTFA. See AM section 0403.14, *Contacts with Third Party Representatives*.
3. **Timeframes** — The audit plan should document the estimated timeframe required to complete the audit. Although not shown in the audit plan, budgeted hours for the entire audit should be established and taken into consideration when estimating the time required for each area of the audit. Establishing a timeframe in the audit plan and adhering to it is critical in completing audits timely. Throughout the audit process, these timeframes serve as benchmarks against which progress is measured. Timeframes should be established for the following:
   - Estimated start and completion dates
   - Scheduled future field appointments
   - Status conferences (AM section 0401.10)
4. **Claims for Refund** — The audit plan should document claims for refund filed and the testing procedures to be used to verify the claimed amounts.
5. **Amended Returns Filed by the Taxpayer** — Determine if any amended returns were filed by the taxpayer and whether copies of returns will need to be requested.
6. **Audit Issues** — Identify known audit issues and the potential tax application or effect. The taxpayer should be informed that additional audit issues may arise during the course of the audit and changes to the audit plan will be made accordingly.

Signing the Audit Plan

The audit supervisor reviews and signs all audit plans before they are presented to the taxpayer. Then the auditor and taxpayer should sign the final completed audit plan, and provide the taxpayer a copy. Signing the audit plan shows a commitment by all parties that the audit will be conducted in the manner discussed and will allow for the timely completion of the audit. If the taxpayer does not agree with the audit plan and refuses to sign, the auditor should make changes, if warranted, in order to reach an agreement with the taxpayer. If the auditor feels no adjustment is warranted, the auditor should consult with the audit supervisor prior to proceeding as provided in the audit plan. Both the taxpayer's and the auditor's position should be documented on both the audit plan and on the CDTFA-414-Z.

The auditor and the audit supervisor should initial and date any amendments to the original audit plan and provide a copy of the amended audit plan to the taxpayer. The auditor should document on the CDTFA-414-Z the delivery of the original and any amended audit plans to the taxpayer, or the reason the taxpayer did not sign the audit plan. Signed copies of the audit plan and copies of all amended audit plans, should be scanned and saved in the *Forms* subfolder of the audit case folder.

PRE-AUDIT CONFERENCE 0401.08

A pre-audit conference is a meeting between the taxpayer and CDTFA staff (including the audit supervisor and computer audit specialist (CAS), if appropriate) prior to the opening conference (start of the audit) to discuss the availability and production of records, including electronic records. While a telephone discussion may suffice for smaller or less complex audits, a pre-audit conference is required on larger or more complex audits, especially those where electronic records are involved. After the auditor conducts the preliminary overview work on the audit, he or she will have the ability to determine whether a pre-audit conference is warranted.

The pre-audit conference may occur several months before the first day the field work begins. Among other things, such as discussion of staffing and resources that are needed by the taxpayer and CDTFA staff, a pre-audit conference provides for a discussion of the records that are required, the period for which requested records are available, the manner in which they are to be furnished, and the timeframe in which they are to be made available. Participation in a comprehensive pre-audit conference by key taxpayer and CDTFA staff will minimize the likelihood of misunderstanding and reduce delays in retrieving records.

Prior to the pre-audit conference, the auditor should send the taxpayer the appropriate Form CDTFA-80 series, Audit Engagement Letter, to confirm arrangements to begin the audit or to establish contact with the taxpayer. These forms are discussed in AM section 0403.10.

Taxpayers (owners, partners, or corporate officers) should be invited and encouraged to attend the pre-audit conference, even if they have authorized another person to represent them (AM section 0403.14.). The audit supervisor should attend the pre-audit conference, when feasible, to ensure proper direction and control of the audit is in place. In cases involving electronic records, the CAS should participate in the pre-audit conference to discuss the availability of the electronic records, as appropriate. The auditor should suggest that the taxpayer include their information technology staff in the pre-audit conference to discuss the technical aspects of retrieving the necessary electronic records.

The CAS assigned to a specific audit will serve as a technical consultant to the auditor(s) to assist with the electronic records and sampling. At the pre-audit conference, the auditor should inform the taxpayer that technical questions regarding the data may be addressed to the CAS; and all questions and issues related to the audit and scope of work will be handled by the auditor. The CAS should be given access to the CDTFA-414-Z so that the CAS can enter comments as appropriate. For more information about the role of CAS, see AM section 0403.12.

Items to be discussed in the pre-audit conference should include, but are not limited to the following:

- General audit procedures
- Use of Prior Audit Percentage of Error (AM section 0405.33)
- Use of Managed Audit Program (AM section 0435.00)
- Availability of and access to records
- Computer assisted audit procedures
- Relevant sampling issues
- Data transfer process
- Verification of data
- Security of data
- Timeframes for the furnishing and reviewing of records
- Name of the person(s) designated to receive IDRs
- Potential new or emerging issues
- Potential claims for refund

OPENING CONFERENCE 0401.09

The opening conference is considered the start date of the audit since it is generally the first on-site meeting between the taxpayer and CDTFA staff to discuss how the audit will be conducted and to begin the field work. For large or complex audits, the audit supervisor should attend the opening conference to ensure that proper direction and control of the audit are in place.

The opening conference establishes the groundwork necessary to conduct an effective and efficient audit and establishes lines of communication that help build a good working relationship between the auditor and taxpayer. During the opening conference, the auditor and taxpayer will introduce the participants of the audit, agree on a general audit plan, discuss audit processes and procedures, and agree upon expected timeframes. The auditor may charge a reasonable number of hours to the audit for preliminary work such as the overview work, as well as time spent conducting a pre-audit conference.

Introduction of Personnel

At the start of the opening conference, the auditor and supervisor (if present) should introduce themselves to the taxpayer. If the team audit approach is being used, see AM Section 0402.06, *Role of Lead Auditor*.

The taxpayer should also introduce their staff and identify those persons who will be working with the auditor and CDTFA staff on the audit. The auditor should obtain the name, title, and telephone number of the taxpayer's staff in the event that the main contact person is not available or leaves the company during the audit. Taxpayers (owners, partners, or corporate officers) should be invited and encouraged to attend the opening conference, even if they have authorized another person to represent them.

General Discussion

The general discussion at the opening conference is an opportunity for the auditor to perform the following tasks:

- Advise the taxpayer of relevant law sections or regulations pertaining to the taxpayer's business and explain where the information relating to the taxpayer's business is located on the CDTFA website.
- Address any questions the taxpayer may have regarding their rights during the audit or the appeals process.
- Emphasize the CDTFA's expectation of completing the audit within two years, or as appropriate for the size and complexity of the audit.
- Discuss the general history of the taxpayer, including any changes in ownership, acquisitions, changes in product line, going concern, and unusual activities during the period under audit, or current changes that may impact the audit.
- Discuss the facts of any pertinent issue or area within the business, such as how a product is made or where assets and supplies are purchased.
- Determine whether there are known credit issues for which a claim for refund will be filed.
- Obtain a signed copy of Form CDTFA-82, *Authorization for Electronic Transmission of Data*, and discuss the CDTFA policy for emailing taxpayer information (AM section 0101.67).
- Request copies of the returns filed and their back-up to start the review of the taxpayer's filings.

Potential Audit Issues

Auditors should inform the taxpayer of potential audit issues, including potential areas of refund, identified during the cursory review process or established in a prior audit. Possible items to discuss include, but are not limited to:

- **Recurring Audit Issues.** If a prior audit determination is being protested or was changed during the appeals process, the auditor should determine the status of the recurring issues. When applicable, the auditor should discuss any changes to the law or regulations related to these items since the last audit.
- **Potential Areas of Refund**. The auditor should inform the taxpayer of the benefit (i.e., interest offset) of providing a claim for refund early in the audit. The taxpayer should also be notified that if a claim for refund is presented at the end of the audit, the claim for refund may be addressed separately so as not to delay the completion of the current audit.
- **Potential Time Saving Areas.** The auditor should consider and discuss any areas where audit time may be reduced and where efficiencies of reviewing the information can be accomplished.
- **Prior Audit Percentage of Error.** The auditor should discuss the possible use of a prior audit percentage of error. See AM section 0405.33.
- **Managed Audit.** The auditor should discuss the taxpayer's eligibility to participate in the Managed Audit Program. See AM section 0435.00.
- Deletions or additions to the business such as the sale or addition of an asset or entire division.

Taxpayer's Return Preparation

Obtaining information on how the sales and use tax returns for the audit period were prepared will provide valuable information on how to address issues and identify the person(s) within the taxpayer's business who is knowledgeable in given areas. The auditor may want to ask the taxpayer the following questions:

- Who prepared the returns? If it is not the same contact person(s) the auditor is working with, is that individual(s) still available for questions or information?
- Where are the workpapers/worksheets for the tax returns located and what lead-time is needed to obtain them?
- Are the tax return workpapers/worksheets electronic, and if so, in what format?
- Have amended sales and use tax returns been filed during the audit period, and if so, for which periods?
- How were district tax allocations addressed? Is the taxpayer engaged in business in other taxing jurisdictions?
- Are instructions or return preparation guidelines issued to those preparing the returns, and if so, are they available?
- Did the method of reporting change over the course of the audit?

Taxpayer Records

Government Code section 15618 authorizes an auditor to examine records of the taxpayer and of persons doing business with the taxpayer. Revenue and Taxation Code section 7054 provides additional authority for the examination of records pertaining to the Sales and Use Tax Law. Similar provisions are found in other tax and fee programs administered by the CDTFA. Government Code section 15613 authorizes the CDTFA to issue a subpoena for the attendance of witnesses or to produce books, records, accounts and papers.

Taxpayer records (both original and copies) are confidential and must be safeguarded at all times. The auditor should inform the taxpayer that any information provided is confidential and protected. The auditor may not remove records from the taxpayer's or representative's premises without permission from the taxpayer or designee. Records relating to the audit of one taxpayer should not be brought to and accessed/worked on at another taxpayer's location. Receipt of taxpayer original records requires accurate and timely completion of Form CDTFA-945, *Receipt for Books and Records of Account*, by the auditor and must be signed by the taxpayer, with a copy provided to the taxpayer. A scanned copy of the CDTFA-945 should be saved in the Forms subfolder of the audit case folder. For additional information on handling taxpayer's records and preparation of Form CDTFA-945, see AM section 0403.35, *Receipt of Taxpayer's Records*.

In addition to explaining the legal authority for requesting records, the auditor should also explain the reason why specific records are being requested as they relate to the audit. This allows the taxpayer the opportunity to provide or recommend additional or alternative records the auditor may not be aware of that will provide the same information/documentation being requested.

Below are some questions the auditor should ask the taxpayer if not already covered in a pre-audit conference:

- What are the taxpayer's record keeping practices and record retention policies?
- Has anything changed in the taxpayer's record keeping during the audit period or from that of the prior audit?
- What areas of the taxpayer's organization have responsibility for the records that need to be examined? Who is the contact person(s) in each area?
- What electronic records are available and in what format are they stored?
- Has there been a change in accounting software?
- What documents are actually retained?
- What alternative records may be available to assist in auditing a specific area if the requested records are not available?
- How long will it take to retrieve documents from storage? Where is the document storage area located?
- Who should the auditor contact if the primary contact is unavailable or has left the company?

For additional procedures and guidelines when starting an audit, see AM section 0403.20, *Preliminary Examination*.

Photocopies and Scanning of Taxpayer Records

Photocopies or scans of taxpayer records may be needed for documentation of transactions and to support the facts as set forth in the audit report. The taxpayer is required to provide photocopies, or make records available for photocopying or scanning. However, the auditor should limit the request to relevant portions of a specific issue. The auditor should not arbitrarily request photocopies of all records in the audit or a particular area in the audit unless there is a legitimate need for such records.

Additional guidelines:

- It is helpful to establish what procedures the taxpayer would like for photocopying and scanning records or documents. The taxpayer may request that their staff do all of the photocopying and scanning. The auditor should ask who to contact if there are any problems with photocopying or scanning requests.
- In audits where the auditor is permitted to make the photocopies and scans of documents, if the taxpayer requests it, the auditor should provide the taxpayer a copy of all documents photocopied or scanned for the audit file.
- The auditor should not photocopy or scan any documents without first securing the taxpayer's permission. In addition, no photos of any records should be taken using personal cell phones or other personal electronic devices.
- State-issued cell phones may be used for the purpose of taking pictures of taxpayer records. Any pictures and videos taken with a state-issued cell phone should only be for business purposes. The pictures or videos should only be transferred via email or a direct download to the users' machine and then moved to the LAN. When taking pictures of taxpayer records is not conducive (i.e. voluminous amount of records), staff must issue a properly completed CDTFA-945, *Receipt for Books and Records of Account*, when a scanner or photocopier is unavailable. See AM section 0403.35.
- The law may prohibit photocopying or scanning of certain documents. If an auditor encounters this situation in an audit, the auditor should discuss this with his or her supervisor.
- Photocopies and scans of all taxpayer records must be included as part of the audit working papers (AWPs) or properly purged at the completion of the audit.

Discussion of Information Document Requests (IDRs)

The auditor should explain the IDR process and determine who should receive the IDRs. See AM section 0401.12. The auditor should also request a secondary contact in the event the requested documents, data, or other information cannot be provided by the primary contact.

Discussion of Audit Findings Presentation Sheets (AFPSs)

The auditor should explain the AFPS process and how it will be used in the audit. See AM section 0401.14.

Waiver of Limitation

Form CDTFA-122, *Waiver of Limitation*, is a legal agreement that a taxpayer may voluntarily enter into with the CDTFA. The waiver of limitation extends the statute of limitations for specific periods indicated on the form. The auditor should explain how waivers of limitation will be addressed throughout the audit. See AM section 0215.00.

Generally, a waiver of limitation should be requested when:

- The audit is about to commence and the taxpayer requests a postponement in starting the audit.
- The audit is in process and the taxpayer requests a postponement in completing the audit.
- There is a documented understatement or overstatement that cannot be billed/refunded without additional examination and there is insufficient time to conduct an audit that could be used as a basis for a determination before the expiration of the periods.

Reasons for requesting a waiver of limitation should be entered on the CDTFA-414-Z. The auditor should also document any circumstances that may lead to a delay in the audit process. Supervisory approval of the circumstances which necessitated the request for a waiver or extension will be noted on the CDTFA-414-Z before presenting the waiver to the taxpayer. Regulation 1698.5 adds the provision that if the extension of the statute of limitations totals two years or more, the District Principal Auditor must approve the extension before it is presented to the taxpayer for signature. This must also be documented on the CDTFA-414-Z.

If the taxpayer declines to sign a waiver of limitation, the CDTFA may issue a determination for the expiring period(s).

Scheduling Future Appointments

To complete the audit timely, the auditor should establish future audit appointment dates with the taxpayer so that both parties understand the expectations and resources that will be needed to complete the audit. This will establish a commitment to obtaining and reviewing audit work by the next scheduled appointment. Whenever possible, appointments should be scheduled with the intent of completing work efficiently; generally this means scheduling appointments for a full working day.

Use of Taxpayer Facility

Taxpayers may be limited in the space they have available. However, it is appropriate for an auditor to request adequate working space to work efficiently and protect confidential taxpayer records. The availability of office space should not dictate the number of audit staff assigned to complete any given audit. During the pre-audit conference or the opening conference, the auditor should identify the resources needed to conduct the audit, including workspace and electrical outlets. The auditor should inform the taxpayer of how many auditors will be assigned to the audit.

Some taxpayers assign permanent work areas to auditors until the audit is complete or for the duration of a field visit. If an auditor is provided with an office, the auditor should determine who has access to the office and what hours the auditor will have access to the office. If temporary space is assigned, the audit staff may make an agreement with the taxpayer so that records will be made available at the beginning of the first day of each field visit. For security purposes, the taxpayer may require that an auditor obtain and wear an identification or access badge. Generally, auditors are not authorized to sign any confidentiality agreements in order to obtain an access or identification badge. An exception can be made with prior approval from the District Principal Auditor (DPA).

Taxpayer Requests to Change Audit Location

Audits generally take place at the location where the taxpayer's original books, records, and source documents relevant to the audit are maintained, which is usually the taxpayer's principal place of business. A request to conduct the audit at a different location should include the reason(s) for the request. It is the taxpayer's responsibility to provide all requested records at that location. Requests will be granted unless CDTFA staff determines the move will significantly delay the start or completion of the audit, or the CDTFA does not have adequate resources available to conduct the audit at the requested location. Form CDTFA-122 should be requested in all cases where the taxpayer requests a transfer of an audit to another district office.

After an initial request to change the audit location has been granted by CDTFA staff, any subsequent requests for location changes in the same audit period shall be made in writing and include the reason(s) for the request. These subsequent requests will be considered on a case-by-case basis. Approval of these requests is at the discretion of CDTFA staff.

If the taxpayer operates out of a private residence, or has a small office or work environment that will not accommodate the auditor(s), CDTFA staff may require the records be brought to a CDTFA office or taxpayer's representative's office. If the audit is conducted at a CDTFA office, the taxpayer will be provided a receipt for records. See AM section 0403.35.

Exit Conference

The auditor should discuss the purpose of the exit conference and make the taxpayer aware that the exit conference will be held at the conclusion of the audit so that the taxpayer knows what to expect and is aware of the timeframes associated with a response to the audit findings. See AM section 0401.16, *Exit Conference*.

STATUS CONFERENCES 0401.10

There are two kinds of status conferences: (1) meetings between the taxpayer and CDTFA staff held throughout the audit to discuss audit issues and the progress of the audit, and (2) meetings between the audit supervisor and audit staff to discuss the progress of the audit and any audit issues. Status conferences are used to keep lines of communication between the taxpayer and auditor open, as well as keep the supervisor apprised of the audit's progress toward meeting the projected completion date.

- **Status Conference with Taxpayer** – Taxpayers (owners, partners, or corporate officers) should be invited and encouraged to attend status conferences, whether or not the taxpayer has authorized another party to represent them. Status conferences with the taxpayer should be held regularly to measure the actual audit progress with planned benchmarks. Supervisors are encouraged to attend status conferences when available or when there is a need for their presence (complex issues, delays, slow progress). The auditor should record a summary of each status conference on the CDTFA-414-Z. However, some audits may not require a status conference, particularly in smaller audits where issues are quickly resolved. When an actual meeting between the audit staff and the taxpayer or representative is not possible or practical, a telephone conference with the taxpayer or representative may be sufficient and this type of meeting should be recorded on the CDTFA-414-Z.
- **Status Conference with Audit Supervisor and Staff** – Status conferences should be held between the auditor (or audit team) and audit supervisor on a regular basis. Status conferences should also be held between the lead auditor and the audit team on a regular basis. These conferences provide an opportunity to make needed adjustments to keep the audit on track with the planned completion date. This includes evaluating the initial budgeted hours and making adjustments to the budgeted hours or workload assignments, if necessary. The audit supervisor should record the discussion held with the auditor or the audit team on the CDTFA-414-Z.

Discussion of Information Document Request (IDR)

While IDRs (AM section 0401.12) are generally discussed separately, the status conference provides an opportunity for the auditor to:

- Review outstanding and new IDR requests;
- Review the timeframes for outstanding and new IDRs;
- Discuss IDR requests that cannot be resolved with taxpayer;
- Address taxpayer's questions regarding the materiality of an issue/area that is the subject of an IDR; and
- Discuss the consequences of non-compliance with an IDR, such as the issuance of a subpoena.

Discussion of Audit Findings Presentation Sheet (AFPS)

AFPSs (AM section 0401.14) are generally discussed when they are provided to the taxpayer. The status conference provides an opportunity for the auditor to:

- Discuss and try to reach agreement on the facts related to the audit issue or describe what facts are still not agreed to, even if there is disagreement with the application of the law;
- Discuss follow-up requests on outstanding AFPS, with specific expectations for completion; and
- Provide follow-up written confirmation of any agreements or understandings that resulted from prior meetings.

Scheduling Audit Appointments

Status conferences provide the opportunity to review any audit appointments that were previously made and to cancel, postpone, or make new appointments in order to keep the audit moving towards completion. The audit plan should be revised to reflect any changes.

Resolving Disputes Related to the Conduct of the Audit

The auditor should immediately discuss any disputes (conflicts/issues) concerning the conduct of the audit with the taxpayer. This may include, but is not limited to, interpersonal disputes, disagreement of where the audit takes place, or the type of testing being performed. The auditor should not wait until the end of the audit to resolve any conflicts; they should be discussed during an audit appointment or during a status conference. If the dispute is not resolved between the auditor and the taxpayer, assistance from the audit supervisor should be requested. If the audit supervisor and the taxpayer are unable to resolve the issue, the taxpayer or audit supervisor may request DPA assistance to resolve the issue. If the issues/dispute cannot be resolved and discussions have been previously held with the taxpayer representative, bookkeeper, or tax manager, it may become necessary for the DPA or District Administrator to advise the owner, partner(s), LLC Member or Chief Financial Officer of the issue and seek resolution with their assistance. When necessary, the Deputy Director, Field Operations Department may need to seek resolution of the issues.

INFORMATION DOCUMENT REQUEST (IDR) 0401.12

The purpose of issuing an IDR (Form CDTFA-698-A) is to document and provide a written request for information/documentation when the taxpayer fails to provide the records in response to verbal requests for the same records. The IDR process includes the issuance of an initial IDR, a second IDR, and a Formal Notice and Demand letter to furnish the information/documentation. Before auditors proceed with the IDR process, taxpayers should be allowed to comply with verbal requests for the same records. However, when CDTFA staff is unable to make verbal contact with the taxpayer, the auditor may proceed directly with the IDR process. The auditor has the discretion to determine reasonable response times for verbal requests. The auditor should discuss the IDR process and significance of issuing an IDR with the taxpayer at the opening conference.

The IDR should generally contain a request for records for a single area of the audit as opposed to one IDR for all areas of the audit. A single area IDR assists the taxpayer if questions need to be distributed to different departments. It provides for better organization in monitoring and following up on IDRs and for better organization of AWPs. In the event that a taxpayer is unresponsive or provides incomplete records, the use of the single area format allows the auditor to send a follow-up request using the same IDR, but modified to update the history of the request. Separate IDRs make it easier to document the history of a request (date of the original request, follow-up dates, extensions granted). However, if the taxpayer does not provide any records or minimal records at the beginning of the audit, rather than issuing an initial IDR for each area of the audit, a single IDR may be prepared to request all records necessary to conduct the audit. In such cases, the outlined IDR process should be followed including the issuance of a second IDR and Formal Notice and Demand letter, if necessary.

Auditors should use Form CDTFA-698-C, *Information Document Request Master Log*, to maintain and track all issued IDRs, and to provide a clear focus for the status of IDRs. Copies of the IDR Master Log (either printed or electronic) should be shared with the taxpayer so that all parties have a common understanding of the expectations and status. See Exhibit 15 for an illustration of a completed master log.

NOTE: All IDRs and the IDR Master Log should be included in the *Forms* subfolder of the audit case folder as memo schedules.

Initial IDR

The auditor should issue the initial IDR (Exhibit 13) after verbal requests with due dates for specific information/documentation were made and the taxpayer did not furnish the information/documentation, unless doing so results in a period of the audit expiring under the statute of limitations. If a period of the audit will expire, the CDTFA may issue a determination for an expiring period(s) in lieu of following the IDR process. When the auditor is unable to make verbal contact with the taxpayer, or if the taxpayer has established a pattern of delaying the progress of the audit by not responding to verbal requests, the auditor may proceed directly with the IDR process. All verbal and IDR requests must be documented on the CDTFA-414-Z. The auditor or lead auditor of a team audit will sign the initial IDR before issuance to the taxpayer. The audit supervisor will review the initial IDR before submission to the taxpayer to ensure the information being requested by the auditor is reasonable and relevant to the area being reviewed and that the information being provided by the taxpayer is as stipulated in the IDRs.

All IDR requests will be on Form CDTFA-698-A, *Information Document Request*. The auditor should use the following guidelines when preparing Form CDTFA-698-A

- **Numbering IDRs** — IDRs should be numbered sequentially when they are provided to the taxpayer. They should retain the same number when they are reissued or followed-up on (unless the nature of the information request has changed). For example, an auditor may first prepare an IDR for resale certificates, and thus should be numbered 1. Next, the auditor may prepare an IDR for paid bills, and thus should be numbered 2, and so on.
- **Due Date** —30 days for the initial IDR and 15 days for the second IDR, measured from the date the IDR is delivered or mailed to the taxpayer and the person designated by the taxpayer at the pre-audit or opening conference to receive IDRs.
- **Signature** — The auditor or lead auditor of a team audit should sign the initial IDR before issuance to the taxpayer. The audit supervisor should sign the second IDR before issuance to the taxpayer.
- **Subject** — Generally, the area of the audit for which information or records are requested.
- **Description of Request** — Identify the information or documents requested. Clearly state the reason for the request and provide any applicable law or regulation references if appropriate.
- **History Section** — Enter all requests for information, due dates, and responses by the taxpayer. These will include verbal requests, prior IDRs, follow-ups by the auditor, and partial responses by the taxpayer.

The auditor should discuss the content of an IDR with the taxpayer to ensure the taxpayer understands what information or document is being requested and why. Discussion of the applicable laws and regulations is also essential. The auditor should also discuss alternative documentation if the information requested is not available or will not resolve the audit issue.

If the taxpayer maintains information or records electronically, the IDR should specifically state that electronic records are requested. The taxpayer should not be required to create records in electronic format for audit purposes.

Responding to IDRs

The auditor must contact the taxpayer within 30 days of receiving a response to the initial IDR. However, every effort should be made to contact the taxpayer as soon as a response is received. When the taxpayer provides the requested records, the auditor should either (1) notify the taxpayer the records are sufficient, (2) issue additional IDRs, or (3) notify the taxpayer that additional time is needed to review the records provided and provide the taxpayer with a reasonable date for future contact. All contacts with the taxpayer regarding follow-ups and deadlines must be recorded on the CDTFA-414-Z.

Taxpayers will be allowed 30 days to respond to the initial IDR, measured from the date the IDR is delivered or mailed to the taxpayer and the person designated by the taxpayer at the pre-audit or opening conference to receive IDRs. Due dates for responses to IDRs shall be within the statute of limitations applicable to the audit. The timeframes allotted for responses to IDRs are intended to provide an orderly audit process, but they cannot be used to limit the taxpayer's right to provide information. This means if the taxpayer does provide information while the audit is still open, even if it is after the due date set in the IDR, the auditor must give consideration to and analyze the information received.

Any response other than full compliance with an IDR must be reviewed by the DPA who will determine the course of action to be taken in response to any issues or extensions requested by the taxpayer. The DPA will document his or her recommendations on the CDTFA-414-Z and in any necessary correspondence. All telephone contacts with the taxpayer regarding extensions of IDR due dates must be documented either by a brief letter summarizing the discussion with the taxpayer or an email, as well as documented on the CDTFA-414-Z.

In cases where an extension to an IDR is granted, the auditor should note on the IDR form that an extension was granted, the due date for the extension, and the reason for the extension. A notation to this effect should also be made on the IDR Master Log (Exhibit 15).

Second IDR

If the taxpayer does not provide, by the date due, the documentation requested in the initial IDR, the auditor may proceed directly in preparing a second IDR (Exhibit 14) for the same records. The audit supervisor should review the second IDR to ensure it is prepared correctly before it is issued to the taxpayer. The second IDR will be issued under the supervisor's signature and will include an explanation of the relevance of the records being requested. Form CDTFA-698-A should be used to prepare the second IDR and the appropriate box marked "Second IDR" checked. A copy of the initial IDR should be attached when providing the second IDR to the taxpayer. The history section of the IDR should reflect all requests for information, due dates, extensions granted, and responses by the taxpayer. Taxpayers will be allowed 15 days to provide the records in response to the second IDR measured from the date the IDR is delivered or mailed to the taxpayer and to the person designated by the taxpayer at the pre-audit or opening conference to receive IDRs, unless doing so results in a period of the audit expiring under the statute of limitations. The auditor and supervisor should document all requests for information, due dates, extensions granted, and responses by the taxpayer on the CDTFA-414-Z.

If the taxpayer provides incomplete or missing records, the DPA must review the response and determine if an extension is warranted. In all cases where an extension to the second IDR is provided, and the taxpayer fails to provide the requested records by the due date of the extension, a Form CDTFA-698-B, *Formal Notice and Demand letter*, should be prepared.

Formal Notice and Demand to Furnish Information

Form CDTFA-698-B, *Formal Notice and Demand letter,* (Exhibit 16) should be issued when a taxpayer fails to furnish the requested records in response to a second IDR requesting the same records as the initial IDR. *The Formal Notice and Demand letter* will be signed by the DPA.

The *Formal Notice and Demand* letter should state the due date for the requested records and reference the two previous IDRs (copies of each IDR should be attached). The *Formal Notice and Demand* letter should be sent to the taxpayer (owner, partner, corporate officer, LLC Member), and the person designated by the taxpayer at the pre-audit conference to receive IDRs. The auditor should consider sending a copy of the *Formal Notice and Demand* letter to a representative in addition to the taxpayer's designee to receive IDRs if the designee is uncooperative in responding to previous information document requests. Taxpayers will have 15 days from the date the *Formal Notice and Demand* letter was delivered or mailed to the taxpayer and the taxpayer's designee to receive IDRs, unless doing so results in a period of the audit expiring under the statute of limitations.

The *Formal Notice and Demand* letter informs the taxpayer that if the CDTFA does not receive the requested information, a subpoena may be issued or an estimated liability may be billed (Form CDTFA-698-B provides this statement). Subpoena requests should follow the guidelines set forth in AM Exhibit 4, and should be prepared on Form CDTFA-301, *Subpoena Request Form*. Although individual IDRs are issued for specific areas, a subpoena request should cover all records requested. The subpoena should be considered only when the records are known or believed to exist, the potential liability to be revealed by the records is significant, and all other methods of obtaining the records have been unsuccessful. Because the time to prepare a subpoena request may delay the audit, it is recommended that the subpoena request process begin immediately after the 15 day deadline noted in the *Formal Notice and Demand* letter that was sent to the taxpayer. In the event the taxpayer responds to the *Formal Notice and Demand* subsequent to the 15 day deadline, the subpoena request may be withdrawn.

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

All *Formal Notice and Demand* letters should be included in the *Memos and Misc. Documents* audit subfolder as memo schedules.

AUDIT FINDINGS PRESENTATION SHEET (AFPS) 0401.14

The purpose of issuing an AFPS (Exhibit 17) is to present the auditor's findings for each area of the audit as it is completed. It communicates to the taxpayer specific audit findings regarding an issue or area within an audit and allows the taxpayer to address those findings while the auditor continues to work on other areas of the audit. The purpose and use of the AFPS form should be discussed at the opening conference.

AFPSs should be prepared in all large and complex audits with multiple areas of tax change. It is not necessary to prepare an AFPS for no-change audits or audits with only one or two areas of tax change that are clearly defined. Although the use of AFPSs was initially intended for use in larger or complex audits, its use will be helpful in organizing and presenting tax errors to all taxpayers.

An AFPS should be issued during the course of the audit as soon as each area of the audit is completed. For example, if an auditor has completed the examination of fixed asset accounts, and will begin the sales for resale test, an AFPS should be issued for the fixed asset examination. An audit area is considered complete when the auditor has completed all of the verification and the taxpayer has been given the opportunity and resources to provide documentation to refute the audit findings for that area. Issuing an AFPS provides the opportunity to conclude and resolve issues during the audit rather than addressing all issues/areas at the conclusion of the audit.

Preparing and Issuing AFPSs

AFPSs should be prepared on Form CDTFA-699, *Audit Findings Presentation Sheet.* Space is provided for the discussion of the specific issue, the facts developed, the relevant law, and the audit recommendation on the issue. All AWPs associated with the respective issue or area, including the lead and subsidiary schedules, should be provided. The auditor should include as much detail as possible on the AFPS to isolate the errors in contention. In a team audit, the lead auditor should review and approve all AFPSs before presentation to the taxpayer. If an issue is controversial or complex, an AFPS, along with the related AWPs, may be reviewed by the audit supervisor or district reviewer, when appropriate, prior to providing the AFPS to the taxpayer. All issuances of AFPSs, follow-ups, and deadlines must be recorded on the CDTFA-414-Z.

The following guidelines should be used when preparing Form CDTFA-699:

- **AFPS Number** — AFPSs should be numbered sequentially at the time they are issued starting with the number 1. Auditors may assign numbers differently in order to facilitate team audits, but it is imperative that the taxpayer understand the numbering system so that they are not looking for a "missing AFPS" which has not been issued.
- **Audit Area/Issue** — Provide a short description of the audit area being addressed.
- **Due Date to Respond** — Follow the guidelines for response times set forth by Regulation 1698.5. This will generally be 30 days from the date the AFPS is delivered to the taxpayer.
- **Description of Findings** — Provide a short description of the findings, schedule reference number, and estimated taxable measure.
- **Summary of Findings** — Provide a summary of the audit findings. Include the methodology the auditor used to determine audited taxable measure if necessary.
- **Law or Regulation** — Cite the relevant statutory law and regulations along with the application of the tax to the facts.
- **Auditor's Position** — State the auditor's findings and conclusions based on the relevant law and facts.
- **Taxpayer's Position** — Ask the taxpayer to indicate their position regarding the audit findings. If they are in disagreement, they should state the reason they do not agree on the back of Form CDTFA-699 and attach any supporting documentation for their position.
- **Taxpayer Signature** — Obtain the signature of the taxpayer or representative (if applicable) and the date the AFPS was signed.
- **Resolution**—If the taxpayer disagrees with the audit findings, the auditor must indicate what steps were taken to resolve any disagreements.

An AFPS Master Log (Exhibit 18) must be maintained to track all AFPSs and to provide a clear focus for all adjustments made. Auditors should use Form CDTFA-699-A, *Audit Findings Presentation Sheet Master Log*, to maintain and track AFPSs. The AFPS Master Log should be shared with audit team members and the audit supervisor. This allows the lead auditor or audit supervisor the opportunity to review AFPSs and monitor the status of the audit. A copy of the AFPS Master Log may also be shared with the taxpayer.

All AFPSs and the AFPS Master Log should be included in the *Memos and Misc. Documents* audit folder as memo schedules.

Taxpayer Response to AFPS

Upon issuance of an AFPS, the auditor should give the taxpayer an opportunity to clarify the facts and provide rebuttal arguments to the audit findings. The taxpayer should be encouraged to respond using the back of form CDTFA-699 or other correspondence. This process can result in the resolution of the issue at the lowest level, minimizing time and costs for both the CDTFA and the taxpayer. The taxpayer should indicate agreement or disagreement with the audit findings and provide additional documentation to support their position if they disagree. The taxpayer should be advised that agreement to an area of the audit through use of an AFPS does not preclude protest or other administrative rights (Form CDTFA-699 contains this statement).

Response times may vary, depending upon the difficulty and complexity of the issue or area and the amount of discussion that has already taken place between the auditor and the taxpayer in advance of issuing the AFPS. The response time should generally be 30 days from the date AFPS was mailed or delivered to the taxpayer. However, due dates for responses to any AFPS shall be within the statute of limitations applicable to the audit. Auditors will consider late responses to an AFPS, provided a period of the audit will not expire due to the statute of limitations. Depending on the area or issue in the audit, some AFPSs can be responded to in less than 30 days. Others will require additional time. The auditor has the discretion to adjust this timeframe as warranted. All responses and follow-ups must be documented on the CDTFA-414-Z.

If the taxpayer does not respond to the AFPS, or returns an AFPS without any indication of whether they agree or disagree, the auditor should make every effort to obtain verbal indication of whether the taxpayer agrees or disagrees. If the taxpayer does not provide any verbal indication, or if the taxpayer wishes to withhold any agreement, it will be assumed the taxpayer does not agree with the audit result for that area. The auditor should enter a "Discussion with Taxpayer" comment in the "General Audit Comments" of Form CDTFA–414–A, *Field Audit Report* (AM section 0207.10).

Revising AFPSs

While every effort is made to ensure the audit findings are correct before the issuance of an AFPS, there are times when an AFPS will need to be revised. For example, once the taxpayer has a clear understanding of the proposed adjustment, the taxpayer provides additional documentation to support their position, or the auditor may find a computational error. Both may necessitate issuing a revised AFPS and providing a copy to the taxpayer for response. A revised AFPS should be issued when:

- Errors are noted in the computation of taxable measure.
- Additional material facts are provided.
- A different section of the law is applicable rather than the one(s) stated in the original AFPS.
- Any other adjustment to the audit findings is deemed warranted.

The auditor should use the same numbering for the revised AFPS as the original AFPS, with some indication that it is a revised version. For example, AFPS 1 is for sales for resale. When a revised AFPS is issued, it should be numbered 1-A. The second revised AFPS should be numbered 1-B, and so on. The auditor should note in the Master AFPS Log that a revised AFPS was issued. The auditor should retain copies of all AFPSs that have been provided to the taxpayer.

If the auditor determines that a revised AFPS is not warranted based on the taxpayer's response, the auditor should make a comment in the resolution section of the AFPS and provide a copy to the taxpayer. The taxpayer's responses to AFPSs should not be included in the audit package without a comment being made in the resolution section as to how the taxpayer's response was addressed and why.

Withdrawing an AFPS

In some cases, the taxpayer might provide additional information/documentation resulting in a no-change in a particular area of the audit. The AFPS should then be formally withdrawn. This can be accomplished by using the original AFPS, adding a comment in the resolution section that provides a brief explanation of the reason for the withdrawal and providing a copy to the taxpayer. The Master AFPS Log should be updated to reflect the AFPS withdrawal

EXIT CONFERENCE 0401.16

The purpose of an exit conference is for the auditor and taxpayer to discuss and review the final audit findings. The exit conference is generally held after the field work has been completed; however, an exit conference may also be held on the last day of the field work. The auditor assigned to a particular area of the audit should methodically lead the taxpayer through the AWPs, discussing the results of each area of the audit. The auditor may want to recap any findings previously discussed in status conferences or through an AFPS.

The auditor should provide the taxpayer a digital copy of the final AWPs (unless the taxpayer specifically requests a paper copy), prior to the exit conference so the taxpayer has the opportunity to review them. When providing a copy of the digital AWPs, the auditor must redact or remove files containing confidential information such as Federal Tax Information or CDTFA-1164s. If the auditor has not completed the AWPs prior to the exit conference, he or she may provide the taxpayer a copy during the exit conference.

If at the time of any discussion the AWPs are not complete, the auditor may provide digital copies of all schedules that were used in the discussion with the taxpayer. Once the AWPs are completed, the auditor should ensure the taxpayer receives a copy of the final set of AWPs either by mail, encrypted email, or hand-delivery. Delivery of the AWPs should be documented on the CDTFA-414-Z.

Who Should Attend the Exit Conference?

Generally the auditor will facilitate the exit conference. Taxpayers (owners, partners, LLC Members, or corporate officers) should be invited and encouraged to attend the exit conference, even if they have authorized another party to represent them. At a minimum, the auditor should request the person who primarily handled the audit for the taxpayer, be present at the exit conference. The audit supervisor should attend the exit conference when the audit tax liability is above $25,000, when it is likely the taxpayer will disagree with the audit findings, or when there is an evasion penalty.

Agenda for the Exit Conference

In addition to an explanation of the audit findings, the following are suggested topics for the exit conference:

- **Review Process** — The auditor should explain the CDTFA's review process (by the audit supervisor and reviewer) and provide an estimated date the audit will be submitted for review. The taxpayer should be made aware that the audit is not final until after the review and billing process. Any AWPs adjusted as a result of the review process will be provided to the taxpayer as soon as possible.
- **Timeframe to Provide Additional Documentation** — Generally, taxpayers will be allowed 30 days from the date of the exit conference to indicate whether they agree or disagree with the audit findings, unless doing so results in a period of the audit expiring under the statute of limitations. If the taxpayer disagrees with the audit findings, they may provide additional information within these 30 days for the auditor to consider. The auditor may adjust the audit findings if warranted based on the information provided.
- **Correspondence from the CDTFA** — The auditor should explain the letters or notices the taxpayer can expect to receive from CDTFA, such as the formal audit report, the 10-day hearing process, CDTFA-836-A, *Report of Discussion of Audit Findings,* and the *Notice of Determination.*
- **Prepaying an Audit Liability** — The auditor should provide the taxpayer an estimate of when a *Notice of Determination* may be issued. The auditor should also inform the taxpayer how to download a copy of Form CDTFA-1, *Audit Prepayment Information*, and explain how to prepay an audit liability to stop the accrual of additional interest.
- **Petition for Redetermination, Administrative Protest, Claim for Refund and Settlement** — The auditor should inform the taxpayer how to download a copy of Publication 17, *Appeals Procedures: Sales and Use Taxes and Special Taxes*, and explain to the taxpayer their protest and appeals rights.

Exit conferences are also addressed in AM section 0207.00.

CONCURRENT AUDITS 0401.18

Generally, the CDTFA will not hold in abeyance the start of an audit pending the conclusion of an audit of prior periods or pending completion of an appeal of a prior audit currently in the CDTFA's appeals process. In cases where a prior audit is under appeal and the audit for the subsequent periods is not held in abeyance, the CDTFA will begin the current audit by examining areas that are not affected by the outcome of the appeal. However, each audit engagement should be considered on a case-by-case basis and the decision whether to postpone the subsequent audit or begin the subsequent audit will be at the discretion of the District Administrator.

TEAM AUDITS 0402.00

OVERVIEW 0402.01

To accelerate the completion of audits, the CDTFA has implemented a team audit approach. However, not all audits may be conducive to or require the audit team approach and use of a team audit will be at the discretion of the audit supervisors or District Principal Auditor (DPA).

The implementation of the team audit approach is beneficial to both the CDTFA and the taxpayer as it provides for a more efficient and effective audit program. Team auditing will increase productivity by reducing the time necessary to complete an audit which ultimately decreases the disruption to the taxpayer's operations.

In the team audit approach, the team consists of one lead auditor and one or more audit team members who will work on the audit through its completion. This approach allows the lead auditor to manage the audit workload and timeframes within the time constraints of each audit. It provides less experienced audit staff an opportunity to participate in auditing large and complex businesses that they would not otherwise experience early in their career. Thus, team auditing is an effective and efficient training tool that will prepare and train audit staff to conduct these types of audits in the future.

District Audit Workload

Once accounts are selected for audit and prioritized, each district office should review their available audit cases for application of the team audit approach. A list of viable audit cases should be developed at the beginning of each fiscal year and assigned according to priority. Regular meetings between the DPA and the audit supervisors should be held to ensure priority audits are addressed. Neighboring districts should work cooperatively and seek assistance from one another to ensure that priority work is planned for, managed, and conducted in a timely manner.

Selecting Audit Teams

An audit team may be comprised of auditors from any classification. Audit supervisors should meet regularly to discuss the availability of audit staff in relation to the scheduled audits. The audit supervisors, in conjunction with the DPA, will select the lead auditor and the team members required for a specific audit. The number of audit teams should be distributed equally between supervisors when possible. If an audit team consists of auditors from various audit crews, the supervisor of the lead auditor is the designated supervisor for that audit team.

Additional guidelines when selecting audit teams are as follows:

- Lead auditors and their respective team members should encourage each other to be focused and productive.
- Less experienced auditors should initially be assigned to work on the smaller, less complex segments of large or medium size audits. As these auditors progress, they should be assigned to work on more complex segments of the audit.
- Each audit team member should be assigned a specific area(s) or segment(s) of the audit.
- Not all audit team members must be present at a taxpayer's location at the same time for a specific appointment. However, the audit team members should be aware of their workload in any given audit and the timeframe within which to complete a designated topic, area, or segment.
- For continuity between audits, a previous audit team member may be assigned as the lead auditor on a subsequent audit of the same taxpayer. However, the lead auditor of the prior audit may not be assigned as the lead auditor in the subsequent audit of that same taxpayer.

- Smaller audits may also be conducive to the team auditing approach; however, smaller audits may require fewer audit team members than larger audits. Smaller audits should also be considered as training audits for new audit staff.
- Auditors may work on more than one team audit concurrently.
- Auditors who are assigned as audit team members on large assignments may also be assigned to work on their own smaller, individual audits as time permits.

ROLE OF THE AUDIT SUPERVISOR 0402.04

The role of the audit supervisor in team auditing cannot be over-emphasized, especially when an office has multiple audit crews with audit team members crossing supervisory lines. Audit supervisors should work closely together to establish the best audit team for each audit.

Planning/Reviewing

To assist the audit team in effective planning, the audit supervisor should:

- Communicate the goals of the audit to the lead auditor and the audit team members to keep them focused on completing the audit timely;
- Provide adequate resources to assist in the timely completion of the audit;
- Ensure the appropriate delegation of tasks, not only to complete the audit, but to further develop audit team members' audit skills; and
- Work with the lead auditor to review the prior audit and other completed audit assignments that will help identify successful audit techniques and avoid those that are less productive.

The following documents are subject to the audit supervisor's review and approval during the course of the audit:

- Audit Plan (AM section 0401.07) — The audit supervisor is required to review and sign all audit plans prior to submission to the taxpayer. The audit supervisor should also make a comment on the CDTFA-414-Z, documenting his or her approval.
- Information Document Request (IDR) — The audit supervisor is required to review each initial IDR to ensure it is correct and the information being requested is reasonable and relevant to the area being reviewed. In addition, the audit supervisor should ensure that the information requested is provided by the taxpayer as stipulated in the IDRs. If necessary, a second IDR requesting the same records as the initial IDR, may be issued. The second IDR must be reviewed and signed by the audit supervisor. The second IDR should provide an explanation of the relevance of the records being requested. The audit supervisor should document their review of each IDR on the CDTFA-414-Z. For more information on IDRs, see AM section 0401.12.
- Audit Findings Presentation Sheet (AFPS) — In a team audit, the lead auditor should review and approve all AFPSs before presentation to the taxpayer. If an issue is controversial or complex, an AFPS, along with the related AWPs should be reviewed by the audit supervisor prior to providing the AFPS to the taxpayer. Early review of any AFPSs by the supervisor will reduce the time spent by the supervisor in reviewing the entire audit package at the end of the audit. For more information on AFPSs, see AM section 0401.14.
- Waiver of Limitations (Form CDTFA-122) — The audit supervisor should ensure that no periods within the audit expire under the statute of limitations and the taxpayer does not request any unreasonable delays in completing the audit.

- CDTFA-414-Z (AM section 0221.00) — The audit supervisor should provide all team members, including the CAS, access to the team audit's CDTFA-414-Z in the 414-Z Program. The audit supervisor should review the CDTFA-414-Z on a regular basis to stay current on the audit's progress and provide guidance to complete the audit timely.
- Formal Notice and Demand Letter — The audit supervisor will review the formal demand for the production of books and records prior to submission to the DPA for approval and signature.
- Subpoena Requests — The audit supervisor and DPA will review all subpoena requests prior to submission to the District Administrator for approval and signature.

Budgeted Hours/Time Management

The audit supervisor assigns the initial budgeted hours for all new audit assignments. When setting budgeted hours for team audits, the audit supervisor should:

- Establish initial budgeted hours for audit assignments of accounts with no prior audit history by using historical hours per audit by industry, auditor experience, and other relevant factors.
- Establish budgeted hours based on hours spent on the prior audit in combination with the factors noted above if an audit assignment has a prior audit of the taxpayer's business.
- Have the flexibility to assign initial budgeted hours that differ from the average in-state and out-of-state hours.
- After the completion of the audit, review the variance, if any, between budgeted and actual hours, and discuss with the audit team the lessons learned, both positive and negative, so that future audits can duplicate successful techniques and procedures, and avoid those that were less productive or less efficient.

Communication

To assist the lead auditor and audit team members in maintaining effective communication in the audit, the audit supervisor should:

- Arrange for one-on-one meetings with the lead auditor or audit team members when necessary;
- Keep their *Outlook* calendar up to date in the event a meeting needs to be scheduled;
- Attend the pre-audit conference, opening conference, any status conferences, as well as the exit conference with the taxpayer when available;
- Oversee the development and mailing of correspondence to taxpayers (owners, corporate officers) where the taxpayer's representative(s) delays the audit by not providing the necessary books and records or when requested information is not furnished on a timely basis; and
- Hold regular status meetings each month with staff to ensure the audit team stays on track for the timely completion of the audit. The meetings should include discussions on current audit findings, foreseeable audit and scheduling issues, and the overall progress of the audit. Status meetings are also an appropriate time for the audit supervisor to review required forms such as the audit plan, IDRs, AFPSs, waivers, and the CDTFA-414-Z. Audit team members should be prepared to provide a copy of their Form CDTFA-609-A, *Auditor's Time Report,* for review by the audit supervisor and lead auditor. Budgeted hours and any necessary amendments should also be discussed. These regular status meetings will help ensure the audit team stays on track for timely completion of the audit.

With respect to field visits, the audit supervisor should:

- Make his or her presence known to the taxpayer as early on in the audit as possible. The presence of the audit supervisor at the taxpayer's location during an audit imparts a sense of urgency to expedite the audit process and lends credence to the work being performed by the lead auditor and the audit team members.
- Visit the business location on a regular basis, where feasible, to review the progress being made and to answer any questions that may arise.
- Allow the lead auditor to be in control of the pre-audit conference, opening conference, status conferences, and the exit conference with the taxpayer. However, the audit supervisor should be present to offer assistance and answer questions.
- Introduce the next audit team. If a subsequent audit is scheduled during the last field visit or at the exit conference, the audit supervisor should bring in the next team of auditors and introduce them to the taxpayer or taxpayer's representative to establish the next audit cycle. The supervisor should attempt to retain one or more of the prior audit team members as part of the new audit team.

ROLE OF THE LEAD AUDITOR 0402.06

The lead auditor sets and communicates the goals of the audit, organizes the work, and ensures adherence to timelines. The lead auditor listens objectively and communicates expectations and instructions to both taxpayers and audit team members. The lead auditor also encourages a cooperative, productive, and positive atmosphere while promoting adherence to CDTFA policies and procedures.

The lead auditor is responsible for the overall management of the audit and is involved in the decision making in all aspects of the audit. The lead auditor:

- Acts as the main contact person and liaison between taxpayer and CDTFA during the audit;
- Interacts with various levels of professional and managerial staff;
- Distributes, prioritizes, and reviews the work of audit team members; and
- Communicates and negotiates with taxpayers on sensitive issues and problems.

The lead auditor is a role model and should:

- Be professional in all interactions with taxpayers, representatives, supervisors, and other audit team members;
- Provide guidance to audit team members on complex tax and audit issues; and
- Promote and develop the strengths in each audit team member, thereby improving their skills.

Planning/Reviewing

Overview

The lead auditor is responsible for reviewing the taxpayer's history and prior audit(s) and determining the scope of the expected audit. This generally takes place in the period prior to the opening conference when the auditor performs most of the preliminary overview work. This includes analyzing tax returns, transcripts, the taxpayer's account (including ownership); reviewing the prior audit history; researching the business and industry; and performing other information gathering techniques that provide the auditor with a better understanding of the taxpayer's business and potential audit issues.

Audit Plan (AM section 0401.07)

An audit plan is required on all audits. The lead auditor is responsible for the development of a detailed audit plan for each assignment. The lead auditor should develop an audit plan that strives for completion of an audit within a two-year timeframe, where applicable, commencing with the date of the opening conference and ending with the date of the exit conference. While most audits will be completed in a much shorter timeframe, others may require a period beyond two years.

The audit plan should include all areas under audit: the audit procedures to be used, timeframes, deadlines and estimated completion dates. The lead auditor should:

- Discuss the audit plan with the audit supervisor and audit team members;
- Assign the tasks within the audit plan to the audit team members;
- Make audit team members aware of all audit appointments and whether or not they are expected to be present;
- Work with the audit supervisor to develop budgeted hours for the audit and/or for each member of the team, or for each area of the audit for which they are assigned;
- Present the audit plan to the audit supervisor for review and signature prior to it being submitted to the taxpayer; and
- Discuss and provide a copy of the draft audit plan to the taxpayer at the opening conference, or when necessary for the auditor to first review the taxpayer's records, within 30 days from the opening conference.

Contact with the Computer Audit Specialist (CAS)

The lead auditor should consult with the CAS during the planning stages and throughout the audit as deemed necessary to determine the electronic records that are needed and to prepare appropriate sampling plans. While considered a member of the audit team, the CAS will serve in a consulting capacity while the lead auditor is responsible for making decisions regarding the audit approach. Additional guidelines with respect to working with the CAS are as follows:

- The lead auditor should introduce the CAS to the taxpayer at the pre-audit conference.
- The taxpayer may address specific technical questions regarding the data to the CAS;
- however, the taxpayer should be made aware that all questions and issues related to the
- audit approach and scope of work should be discussed with the lead auditor.
- The lead auditor should routinely follow-up with the CAS on the status of the taxpayer's electronic data analysis.

Budgeted Hours/Time Management

Budgeted Hours

The lead auditor should work with the audit supervisor to determine the budgeted hours for each assignment. The budgeted hours should be based on factors such as the size and complexity of the business, number of audit team members, and the hours used in prior audits. While the audit supervisor will ultimately set the initial budgeted hours during the planning stage, it is the responsibility of the lead auditor to approach the audit supervisor to discuss any changes in theaudit plan that will affect the actual number of hours on the audit. Through discussion with theaudit supervisor, the estimated number of hours may be revised based on changing circumstances in the audit.

Overall Time Management

The lead auditor is responsible for the overall time management of the audit. Some general time management techniques include continuous monitoring of the audit, establishing reasonable timeframes for the taxpayer and audit team members, setting deadlines, confirming deadlines in writing, and following-up on those deadlines. Additional time management procedures the lead auditor should use include, but are not limited to:

- Scheduling a pre-audit conference (where applicable);
- Adhering to the timelines set forth in the audit plan (or amended audit plan), and ensuring adequate resources to do so;
- Ensuring audit team members are aware of audit appointments and whether or not they are expected to be present;
- Ensuring audit team members have adequate work and are actively working towards completing their assigned area of the audit timely;
- Holding regular status conferences with the taxpayer;
- Holding regular status meetings with audit team members and holding all audit team members accountable for their assigned audit areas and timeframes;
- Comparing Form CDTFA-609-A, *Auditor's Time Report*, of each audit team member with the audit plan and discussing this with the audit supervisor to make sure the hours are reasonable for the work performed; and
- Preparing timely status reports on all audits for supervisor/management review.

Preparation of Information Document Request (IDR) (AM section 0401.12)

When a taxpayer or their representative fails or refuses to provide records or supporting information/documents in response to verbal requests for the same records, (or when otherwise appropriate), the lead auditor is responsible for preparing and tracking IDRs. However, before proceeding with the IDR process, taxpayers should be allowed to comply with verbal requests for information/documents. The lead auditor has the discretion to determine reasonable response times for verbal requests.

As part of the IDR process, the lead auditor should:

- Prepare, maintain, and track all IDRs issued during the course of the audit;
- Sign the initial IDR before issuance to the taxpayer;
- Ensure all IDRs are presented to the audit supervisor for review;
- Timely follow-up with the taxpayer within 30 days on all IDR responses received from the taxpayer;
- Notify the audit supervisor if any IDRs are not responded to in full;
- Assist in the preparation of the appropriate *Formal Notice and Demand* letter if the taxpayer fails or refuses to provide the information stipulated in the initial IDR and the second IDR; and
- Prepare the request for a subpoena for the production of books and records for the audit supervisor's and DPA's review and district administrator's approval, when appropriate.
- Document all verbal and IDR requests on the CDTFA-414-Z.

Preparation of Audit Findings Presentation Sheet (AFPS) (AM section 0401.14)

During the course of an audit, one or more areas may be completed prior to the completion of the audit as a whole. An AFPS should be prepared for each area upon completion and provided to the taxpayer. The following guidelines should be followed when preparing AFPSs in a team audit:

- The lead auditor must ensure that the audit team members complete the appropriate AFPS for the respective segment or area for which they are responsible.
- The lead auditor must review all AFPSs with audit team members before presentation to the taxpayer. If an issue is controversial or complex, an AFPS along with the related AWPs should be reviewed by the audit supervisor prior to providing the AFPS to the taxpayer.
- The audit team member responsible for the respective audit segment or area should participate with the lead auditor in the discussion of the AFPS with the taxpayer. The lead auditor should be present to answer any questions and to assist in the resolution of non-concurred issues.
- In general, within 30 days of the taxpayer providing additional information in response to an AFPS, the lead auditor must notify the taxpayer if an adjustment to the audit is warranted based upon the information provided. It is the duty of the lead auditor to notify the audit supervisor and taxpayer if this timeframe cannot be met.

Communication

The lead auditor's communication skills are key to an effective team audit. The lead auditor is the central communication point between the taxpayer, the audit supervisor, and audit team members. To ensure effective communication in the audit, the lead auditor must:

- Keep their *Outlook* calendar up-to-date;
- Periodically discuss the status of the audit with the audit supervisor (at least monthly);
- Provide prompt responses to the audit supervisor's questions and requests;
- Continually communicate with team members;
- Ensure all audit team members are aware of all audit appointments and whether or not they are expected to be present;
- Make regular, appropriate, and timely comments on the CDTFA-414-Z (at least weekly, or when appropriate) and ensure audit team members do the same;
- Keep the taxpayer continually informed of the status of the audit and prepare appropriate written correspondence when necessary;
- Prepare timely IDRs;
- Coordinate the preparation and presentation of AFPSs;
- Ensure audit team members provide prompt responses to the reviewer's questions or "go-backs" on a timely basis; and
- Regularly communicate with other lead auditors in the office or other districts to discuss experiences and difficulties encountered, and share ideas for successful team audits.

Working With Audit Team Members

The lead auditor should delegate tasks and assignments in a way that enables work to be completed efficiently and that challenges and develops audit team members. Audit team member duties and responsibilities should be appropriate for each classification, knowledge and experience level. This does not preclude experienced audit team members or the lead auditor from performing basic verification work, should the need arises. Lead auditors are expected to work with the audit team members for the timely completion of an audit and not simply delegate work.

Additional guidelines when working with audit team members are as follows:

- The audit team members should participate in developing the audit plan.
- Audit team members should be made aware of all audit appointments, and be asked to attend all conferences with the taxpayer regarding the area in which they worked whenever possible.
- Audit team members should back up their work on the J:\Drive as necessary, but at least once a week. However, the audit team members should provide the lead auditor with an electronic copy of the work they completed at the end of the field visit, or when any changes to the schedules or AWPs are made throughout the course of the audit. The lead auditor should always maintain a complete set of the most current electronic AWPs.
- When an audit team member has finished their specific audit area, they should be redirected to assist on another area of the audit, or should be released to conduct other audit assignments at other taxpayer's locations.

The lead auditor should address and appropriately resolve minor issues regarding audit team members. The lead auditor should also provide the audit supervisor feedback, both positive and negative, regarding audit team members' performance and productivity.

Conducting the Audit

The tone for the audit should be set early and an open line of communication with the taxpayer should be encouraged throughout the audit process. The lead auditor should promote a collaborative relationship with the taxpayer from the inception of the audit and encourage the taxpayer's cooperative participation in the audit process.

The lead auditor is responsible for setting appointments and conducting meetings with the taxpayer. These meetings include the pre-audit, opening, status, and exit conferences. The audit team members should be present to assist the lead auditor with the meetings and whenever possible, the audit supervisor should be present. At the opening conference, the lead auditor should introduce him or herself, the audit team members, and provide, in writing, the name and phone number of the audit supervisor and all audit team members.

The lead auditor should explain the audit team's reporting lines to the taxpayer and each team member's role in the audit, including the area or segment in the audit that each team member will be responsible for completing. Changes in personnel during the course of the audit should be timely communicated to the taxpayer.

The lead auditor is responsible for securing, monitoring, and maintaining the waiver of limitations status and obtaining necessary extensions. The lead auditor should inform the supervisor of the circumstances that necessitate a request for a waiver, and ensure supervisory approval is documented on the CDTFA-414-Z before the waiver is presented to the taxpayer for signature. If the extension of the statute of limitations totals two years or more, approval by the DPA will be documented on the CDTFA-414-Z.

ROLE OF THE LEAD AUDITOR (CONT.5) 0402.06

At the conclusion of an audit, the lead auditor is responsible for compiling the AWPs into a final product for presentation to the taxpayer. Audit team members should complete the final working papers in their assigned area and be prepared to present them to the taxpayer along with the lead auditor. This includes completing the necessary schedules, forms, and general and subsidiary comments.

At the exit conference (AM section 0401.16), the lead auditor may want to recap any findings previously discussed in status conferences or through an AFPS. The audit team member assigned to a particular area of the audit should lead the discussion of that area. However, the lead auditor should be present to assist with any questions or concerns the taxpayer may have.

ROLE OF AUDIT TEAM MEMBER 0402.08

The role of the audit team member is to work with the audit supervisor and lead auditor to timely complete the audit. The audit team member is not strictly limited to their tasks or assigned area(s) in the audit. A good audit team member contributes to the success of the team. They share helpful ideas and information and may go beyond what is required of them.

Budgeted Hours/Time Management

To assist the lead auditor in managing the time it takes to complete the audit, the audit team member should:

- Complete their assigned tasks timely and inform the lead auditor of any potential delays.
- Keep track of their hours on Form CDTFA-609-A and be prepared to provide the lead auditor and the audit supervisor a copy of the completed form and other pertinent documents during regular status conferences.
- Compare their actual hours to the budgeted hours on the audit plan and notify the lead auditor of any possible differences.

In team audits, each area of the audit may be completed in parts rather than simultaneously. The entire team does not need to visit the taxpayer's location all at once, unless all records are available and the taxpayer has the facilities to accommodate all CDTFA staff assigned to the audit team. Thus, audit team members may be scheduled to perform fieldwork at different times, depending on the availability of records or taxpayer's facilities. For example, the taxpayer may have all of the records for a sales test, but not the paid bills test. The audit team member assigned to the sales test will go to the taxpayer's location, but the audit team member assigned to the paid bills test may be working at another taxpayer's location during this time. Once the paid bills are available, the audit team member assigned to paid bills will go to the taxpayer's location to complete their area. It is not necessary for the lead auditor or other audit team members to be in the field at the same time, thus saving the CDTFA and the taxpayer time and resources.

Audit team members who have completed their assigned area(s) of the audit should ask for instructions from the lead auditor on the next area of the audit to be completed. Audit team members may not return to the work location of the team audit to work on audits of other taxpayers.

Communication

During a team audit, the audit team member must effectively convey information and encourage an exchange of ideas. To achieve this, the audit team member should:

- Share helpful ideas and information with the team;
- Proactively inform the lead auditor or audit supervisor of any obstacles that may arise;
- Independently prepare complex oral and written communications;
- Possess the ability to express alternative views in a constructive manner and seek mutually beneficial solutions; and
- Work well with others, even when differences in communication style, viewpoints, or culture exist.

The audit team member should be present at all meetings and discussions for areas in which they worked whenever possible. This includes, but is not limited to, audit plan preparation, the opening, status, and exit conferences with the taxpayer, and any status conferences with the supervisor.

During the opening conference, the lead auditor and audit team members should discuss with the taxpayer which team members to contact if any questions arise in the audit. Furthermore, the lead auditor and audit team member should discuss with the taxpayer which CDTFA staff member the taxpayer should contact if he or she has any questions regarding the audit. Because situations are different, and taxpayers have different preferences of whom they wish to communicate with, these contacts should be established and understood by both the taxpayer and all audit team members at the beginning of the audit. These contacts should also be noted on the audit plan. See AM section 0401.09, *Opening Conference*, for more detailed information.

On a regular basis, each audit team member is expected to enter comments related to the audit in process on the CDTFA-414-Z.

When an audit team member has completed their area(s) of the audit, they must immediately inform the lead auditor so that an AFPS can be prepared. The audit team member who completed the particular area should complete the AFPS. The audit team member may conduct the actual discussion of AFPSs with the taxpayer, if necessary; the lead auditor should be present to answer any questions and to assist in the resolution of non-concurred issues.

Conducting the Audit

Audit team members are assigned different areas in the audit based on their expertise and the complexity of the audit area. Such areas may include tests of sales for resale, paid bills, test of assets, etc. The audit team member is responsible for performing those tasks, as well as completing the write-up for that particular area. This includes:

- Working paper completion — The entire schedule should be completed including calculations and all referencing.
- Projection of error — The audit team member should complete any projection of errors associated with their assigned area.
- Schedule comments — comments related to individual transactions in the schedule, such as disallowed sales for resale or purchases subject to use tax, should be completed by the audit team member.
- General comments — The general comments (Schedule 12 comments) should be completed by the audit team member who is responsible for that area.
- Go-Backs — The audit team member assigned to a particular area is responsible for answering an audit reviewer's question(s) on a go-back regarding that area in a timely manner. The audit team member is also responsible for making any required comments or corrections required by the reviewer.
- IDRs — The audit team member should assist in the preparation of document requests including IDRs and follow-up IDRs, and *Formal Notice and Demand* letters.
- AFPSs — The audit team member responsible for their respective audit segment or area will complete the appropriate AFPS; however, the lead auditor must review all AFPSs prior to presentation to the taxpayer. The audit team member should also participate in the discussion of the AFPS with the taxpayer. Any documentation provided by the taxpayer in response to an AFPS should be reviewed by the audit team member and discussed with the lead auditor as appropriate.

It is the responsibility of the audit team member to be aware of all areas of the audit in case they are asked to fill in for another audit team member. One purpose of the team audit approach is to respond to setbacks with minimal disruption to productivity. If an audit team member is unable to attend a conference or perform fieldwork, it is up to the other audit team members to willingly accept new assignments and change focus as demands may modify the course of the audit. At the exit conference, the audit team member assigned to a particular area of the audit should lead the discussion of that area.

ROLE OF THE COMPUTER AUDIT SPECIALIST IN A TEAM AUDIT 0402.12

The lead auditor is responsible for the audit as a whole. However, the CAS assigned to a specific audit is considered part of the audit team with respect to that audit and will serve as a technical consultant to the auditor(s) to assist with the electronic records and sampling.

The CAS's responsibility is primarily that of obtaining the necessary data, data processing, recommending strata breaks and sample sizes, and sample selection as defined in Form CDTFA-472, *Audit Sampling Plan*. Specific technical questions regarding the data and testing may be addressed to the CAS, however, all questions and issues related to the audit and scope of work should be discussed with the lead auditor.

For detailed information regarding a CAS and their role and responsibilities in an audit, see section 1301.25

PROGRAMMING — AUDIT SURVEY 0403.00

STARTING AN ASSIGNMENT — GENERAL 0403.05

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

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

TRANSFERRING AN AUDIT TO ANOTHER OFFICE 0403.07

When transferring an audit to another district, the auditor should prepare a new audit case using the Excel Audit Program. Although, it is not required to start a new case, it is recommended since forms such as the CDTFA-122, *Waiver of Limitation*, must be prepared in Start21, Form CDTFA-579 must be completed, and an electronic copy of the transcripts downloaded and saved. The auditor may prepare an audit transfer folder (transfer folder) without creating a new audit case folder, however, all forms and supporting documentation must be included in the transfer folder.

Rename the audit transfer folder as follows:

Naming Format: District Code_Case Number_Taxpayer Name_CDTFA 579 to District

Example: EA_54321_ABCO_CDTFA 579 to AA

When sending a transfer folder to another district, the office designator used to name all electronic forms and folders should reference the district of account. Save Form CDTFA-579 in the transfer folder. It can be created in Start21, but a separate copy must be saved in the *Forms* subfolder.

The following forms, if available, must be completed, signed, scanned, or saved in the *Forms* subfolder using the appropriate naming convention as described in Audit Manual section 0302.00:

- CDTFA-122, *Waiver of Limitation*
- CDTFA-392, *Power of Attorney*
- CDTFA-80RU, *Record Update*
- CDTFA-101, *Claim for Refund or Credit*
- CDTFA-82, *Authorization for Electronic Transmission of Data*
- CDTFA-414Z, *Assignment Activity History*
- CDTFA-414M, *Electronic Transcript of Returns*
- Transfer Letter
- Any additional documents

Once the transfer folder has been prepared including all required documents, the auditor will cut and paste the transfer folder to the audit control inbox and notify their audit supervisor of the pending audit transfer. The audit supervisor will then review the transfer folder for completeness and notify Audit Control of the pending audit transfer.

Generally, Audit Control updates IRIS for comments, hours, and transfers; enters “Y” for digital audits on the AUD MC screen; transfers the electronic 414Z to the receiving office; and completes any other IRIS or audit transfer functions. Once all tasks are complete, staff (generally Audit Control) cuts and pastes the transfer folder from the Audit Control Inbox into the *Transfer Documents to Other Districts* folder for the receiving office (generally located on the receiving office’s J:\ drive above the Audit Control Inbox).

Staff sends an email to the receiving office notifying them of the pending audit transfer. After the audit has been transferred, the office making the audit uses its own designator for the audit case folder and files.

Processing Transfer of Audits in IRIS

The transfer of an audit to another office for completion is processed in IRIS by entering the audit into “Transfer Status” (lifecycle event sequence 40). The transferred audit assignment remains in “Transfer Status” until the receiving office receives the assignment and enters it into “Status 15” (RCVD – DO) in IRIS. The transferred assignments must be entered into “Status 15” (RCVD – DO) by the receiving office within 30 days of receiving the assignment.

The AUD AS, “Audit – ASI Parameter Selection,” function in IRIS generates a report that lists all audit assignments that are currently in “Transfer Status” and were transferred to another office. Staff should generate a “Status 40” report from IRIS on a monthly basis, to confirm the audit assignments transferred to their respective offices have been received.

The steps to generate the monthly “Status 40” Reports are as follows:

1. Enter the IRIS system and type AUD AS at the “GO” line.
2. Press Enter.
3. At the Report Selection: line press F1.
4. At the Order Seq: line type in 40 and press enter.
5. At the Ceiling-Event: line press F1.
6. At the Order Seq: line type in 40 and press enter.
7. At the Office: enter your two-letter office designation.
8. At the OMA Exclusive: Change the Y to N.
9. Press Enter and then press PF17 to “Submit the Report” for printing. A report listing accounts currently in “Status 40”, “Transfer to Other Office,” will print with the transfer dates.

PRELIMINARY ARRANGEMENTS 0403.10

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

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

- The IRIS TPS TP screen for prior audit information and petition and claim for refund status. If a "Y" is noted under the appeal category, check the APL PR screen for more information.
- The IRIS COM BA screen for comments input from all IRIS subsystems. If payment problems are noted, the auditor may request that compliance staff review the account on Automated Compliance Management System (ACMS) for additional information.
- The CTS AL screen to find related businesses, accounts or permits with the CDTFA.
- The DIF DA screen to identify any outstanding balance and to determine if any collection action is being taken against the taxpayer.
- The Internet to find information on company history, product lines, store locations, recent mergers and acquisitions, bankruptcies, etc.

(b) Contact the taxpayer to arrange for the following information:

- Exact date and time for starting the audit assignment or a pre-audit conference (AM section 0401.08).
- Records to be available at the start date of the audit.
- Name and position of person to be contacted. (*The auditor must leave his or her name and telephone number with the taxpayer at this time.)*
- Desk space/work area.

(c) Verify registration information, including:

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

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

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

The appropriate CDTFA–80 series "Audit Engagement Letter" should be used to confirm arrangements to begin audits or to establish contact with the tax/feepayer.

CDTFA–80–A	*Audit Engagement Letter – Confirm Start Date*
CDTFA–80–AT	*Transfer Letter – Agreement to Transfer Audit to Representative*
CDTFA–80–B	*Audit Engagement Letter – Agreement to Delay Start Date*
CDTFA–80–C	*Audit Engagement Letter – Initiate Contact*
CDTFA–80–D	*Audit Engagement Letter – 10–Day Follow Up*
CDTFA–80–DOH	*Audit Engagement Letter – 10–Day Follow Up (Out-of-State)*
CDTFA–80–EOH	*Audit Engagement Letter – In Area (Out-of-State)*
CDTFA–80–FOH	*Audit Engagement Letter – Apology (Out-of-State)*

Forms CDTFA–80–A, CDTFA-80-AT, CDTFA–80–B, CDTFA–80–C, and CDTFA–80–EOH contain links to the following publications and provide tax/feepayers with the CDTFA website address so the publications can be downloaded. For tax/feepayers who are unable to download the publications, information is provided on how to obtain them from the Customer Service Center:

- Publication 70, *Understanding Your Rights as a California Taxpayer*
- Publication 76, *Audits*
- Publication 17, *Appeals Procedures, Sales and Use Taxes and Special Taxes*

When conducting use tax audits referred by the Use Tax Administration Section, In-State Service Tax Group (ISS Group), the CDTFA-80-TG series of "Audit Engagement Letters" should be used (see AM section 0408.45).

The CDTFA-80-RU, *Record Update*, is provided as an enclosure with the CDTFA-80-A, CDTFA-80-AT, CDTFA-80-B, and the CDTFA-80-C. The CDTFA–80–RU is intended to help obtain the tax/feepayer's current registration information at the start of an audit. The auditor should verify the accuracy of the information provided by the tax/feepayer on Form CDTFA–80–RU and include a comment to that effect in the CDTFA–414–Z program. A copy of Form CDTFA–80–RU should be included in the *Forms* subfolder of the audit case folder. To update the tax/feepayer's registration information on IRIS, a copy of Form CDTFA–80–RU should be sent to the Compliance Supervisor for sales and use tax accounts and to the Registration and Licensing Section's account maintenance mailbox (BTFD-PCD Reg Maint Close) for special taxes and fees accounts.

Normally, the initial contact with the tax/feepayer will be by telephone. When the audit appointment results from a telephone contact, the appointment must be immediately confirmed by mail or email using Form CDTFA–80–A, *Audit Engagement Letter — Confirm Start Date*, with the CDTFA-80-RU enclosed. If distribution of the engagement letter occurs via email, a CDTFA-82, *Authorization for Electronic Transmission of Data,* must be on file. If the audit will commence within a week of making the appointment, the engagement letter and the CDTFA-80-RU may be given to the tax/feepayer at the start of the audit. If the audit appointment is with the tax/feepayer's representative, the engagement letter and the CDTFA-80-RU should be sent to the tax/feepayer, with a copy to the representative.

The auditor should grant reasonable requests by tax/feepayers to delay the start of an audit, but should be alert to detect attempts to forestall it. If excessive delay in the start date is agreed to, and a reporting period is about to expire, Form CDTFA–80–B, *Audit Engagement Letter – Agreement to Delay Start Date* should be used. Form CDTFA–122, *Waiver of Limitation,* covering a minimum of two quarterly reporting periods should be included along with the CDTFA-80-RU. (AM section 0215.15 provides guidance when a waiver of limitation should be requested.) If the audit is a result of a claim for refund filed by the tax/feepayer, Form CDTFA–146, *Waiver of Credit Interest*, should be obtained.

If the auditor is unable to contact the taxpayer by telephone, Form CDTFA–80–C, *Audit Engagement Letter – Initiate Contact* should be used. If the taxpayer does not respond by the date specified on Form CDTFA–80–C, Form CDTFA–80–D, *Audit Engagement Letter – 10–Day Follow Up* should be sent to the taxpayer. As Form CDTFA–80–D explains, if the books and records are not provided by a specific date, the CDTFA will either issue a subpoena requiring the taxpayer to provide the books and records or prepare a billing for estimated additional taxes due. The books and records must be subpoenaed when an estimated billing has been prepared and the taxpayer, at any time, disagrees with the proposed assessment or determination.

During the course of an audit, if the taxpayer or the taxpayer's representative refuses to provide or claims not to have some or all of the records which the auditor has requested orally, procedures outlined in AM section 0401.12, *Information Document Request*, should be followed. These procedures also apply when the taxpayer refuses to provide access to computerized records that can be used for testing purposes. However, if most of the records are available, or the auditor believes that the requested records do not exist and the estimated deficiency is either small or would not be significantly altered if the records were available, then no further effort should be expended to obtain the records. A letter should be written to the taxpayer confirming that a request for the records had been made, acknowledging that the taxpayer or representatives failed to provide the records requested, and advising that a billing based on the available records is being prepared.

Comments regarding contacts and attempts to contact tax/feepayers, both oral and written, must be documented in the CDTFA–414–Z program. Copies of correspondence referenced in the CDTFA–414–Z program should be included in the *Correspondence* subfolder of the audit case folder. It should be noted in the "books and records" comment of the Field Audit Report or Field Billing Order if any records were withheld or were not available. *The auditor's comments must clearly state the effect the lack of records had on the amount billed.*

VIDEO AND AUDIO TAPING 0403.11

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

An auditor should not consent to videotaping without discussing the request with his or her supervisor. Although there may be limited circumstances where videotaping is approved, generally if a taxpayer insists on videotaping the auditor as a precondition to the availability of the necessary books and records, the taxpayer has in effect refused to cooperate with the auditor and has not made the necessary records available as required by law. Under these circumstances, the subpoena process may be used to obtain the books and records. (See AM Exhibit 4).

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

ROLE AND RESPONSIBILIES OF COMPUTER AUDIT SPECIALIST 0403.12

The goal of the Computer Audit Specialist (CAS) program is to provide specialized technical support and assistance to field audit staff in dealing with electronic records and in the design, implementation and analysis of statistical samples. By leveraging the advanced electronic data analysis techniques and tools used by the CAS, field audits can be performed more accurately and efficiently. The CAS enables audit staff and taxpayers to make more informed decisions regarding the population to be tested, sample size, stratification levels, sample representativeness, statistically proper handling of unusual sample units, sample evaluations, etc.

The CAS serves in a consulting capacity and is required to be consulted on all audits where:

- A previous audit exceeded 400 hours and large volumes of electronic data will be utilized;
- There are large volumes of electronic data;
- A prior audit was performed with a CAS;
- Assistance is needed by the auditor to obtain usable data.

The CAS may also be consulted on other complex audits at the discretion of the audit supervisor. In addition, the CAS supplies expert advice on electronic data downloads, statistical sampling procedures, and sample evaluations, as needed by the audit staff and district audit management.

CAS Coordination with District Principal Auditors or Area Administrators

To enhance communication between the CAS and District Principal Auditor (DPA) or Area Administrator, the CAS staff is required to do the following:

- Schedule and attend monthly meetings with the DPA or Area Administrator to review audits with CAS involvement and discuss their progress.
- Provide access to their Outlook calendars to the DPA or Area Administrator of the districts they reside in and support. CAS staff must keep their Outlook calendars up to date (including approved time off).
- Attend district office staff meetings provided they are notified in advance and are available.
- Establish designated office hours (days and hours they will be in the office). Typically instate CAS have one regularly scheduled office day per week and out-of-state CAS have one office day on non-travel weeks. When exceptions have to be made, the CAS will give the DPA advanced notice.
- The CAS must timely document their work on the CDTFA-414-Z for each account they are working.
- The CAS will report any delays related to their role in the audit directly to the DPA or Area Administrator, Supervising Tax Auditor, and the auditor.
- The CAS will secure the taxpayer's electronic data consistent with the established security policies for taxpayer's electronic data.

General Audit Roles & Responsibilities of the CAS and Audit Staff

The CAS is a member of the audit team and serves as a technical consultant to the auditor(s). The CAS should be available for consultations and to attend meetings and status conferences upon the request of the Audit Supervisor, the DPA or the Area Administrator.

The auditor is responsible for making decisions regarding the audit approach; however, the CAS may offer suggestions pertaining to electronic records and statistical sampling. As such, the development of an audit plan for an audit utilizing a CAS requires a coordinated effort between the CAS and the auditor with the following principles in mind:

- Request records and data that are relevant to the audit.
- Ensure the transaction data is material to the audit.
- Consider the nature of transactions and the ease with which data can be accessed and
- analyzed.
- Ensure timely communication between the CAS and the auditor throughout the development of the audit plan and the audit process.

If there is any concern or disagreement between the CAS and the auditor regarding the audit plan or methodology, the CAS should bring these concerns to the attention of the DPA or Area Administrator, Audit Supervisor and the CAS Supervisor. There should be no discussion of concerns in front of the taxpayer.

The CAS's analysis, evaluation and understanding of the taxpayer's electronic records, and processing of the data will be documented by the CAS for inclusion in the audit verification comments. The CAS's documentation should include a detailed log and reconciliation of how the target population(s) was achieved from the original population provided and the taxpayer's data layout.

Pre-Audit Conference

On accounts where a CAS consultation is required, the lead auditor should contact and meet with the CAS before scheduling the pre-audit conference with the taxpayer. See AM section 0401.08 for more information on the Pre-Audit Conference. At or prior to the pre-audit conference, the auditor will provide the taxpayer a copy of Publication 147, *What to Expect in a Computer Assisted Audit*.

The CAS will attend the pre-audit conference(s) with other CDTFA representatives, the taxpayer and their representative along with the taxpayer's appropriate Information Technology (IT) staff. The pre-audit conference must include an explanation and a discussion of the following issues and documents relating to the CAS involvement in the audit.

- Publication 147, *What to Expect in a Computer Assisted Audit*
- Availability and access to records
- What data fields/elements are maintained in the taxpayer's database
- How data is stored in the taxpayer's computer system
- Checklist for electronic data
- Electronic data transfer process
- Security of taxpayer data
- Validation and reconciliation of data
- Relevant sampling issues
- Timeframes for furnishing and reviewing records
- Work to be performed by the CAS, including work to be performed at the taxpayer's location.

The CAS, auditor and taxpayer should work together to establish reasonable timeframes for the taxpayer to furnish the data requested and the CAS to process the data. The auditor is responsible for following up with the taxpayer to ensure all requested data is provided. The Checklist for Electronic Data will be provided to the taxpayer by the CAS to ensure that all requested data is provided.

The CAS should work with the taxpayer's IT staff to achieve a thorough understanding of the taxpayer's electronic books and records. Whenever possible, the CAS should review the extraction query written by the taxpayer for the requested data to ensure the data provided will be complete, correct and unfiltered.

At the pre-audit conference, the taxpayer should be encouraged to perform their own data validation(s) and reconciliation(s) due to their knowledge and expertise with their accounting system. This will minimize the auditor and CAS time required to complete this task.

Initial Data Analysis

After data is provided by the taxpayer, two key steps must be completed before the data can be used for audit purposes:

1. *Validation* – This refers to reconciling control totals and record counts related to data files provided for use in the audit. Validation is the responsibility of the CAS.

   Depending on the volume of data and number of data files, this may take up to several days by the CAS. The auditor will be contacted immediately via email when the initial validation work is complete. If the data is successfully validated, the CAS will provide the auditor with the necessary data files to complete the reconciliation. If the data cannot be validated, the CAS will inform the auditor and audit supervisor so appropriate action may be taken to secure the necessary electronic records.

   In the event the CAS cannot complete the validation process timely, notification will be made immediately to the auditor and auditor supervisor.
2. *Reconciliation* – This refers to the audit procedure of tracing amounts to the books and records to verify the data provided by the taxpayer accurately represents the amounts recorded in the books and records. The taxpayer and the auditor should come to a consensus that the electronic data received is an accurate and complete representation of the transactions requested.

   While the CAS will provide guidance and assistance as needed to the auditor and the taxpayer regarding the reconciliation of data, it is the auditor's responsibility to ensure the data is verified for accuracy and completeness.

Sampling and Testing

After the electronic data is validated and reconciled, the auditor and CAS will work in a concerted effort with the taxpayer regarding sampling characteristics, such as:

- Population
- Sample size
- Accounts of interest
- Sample units
- Cost centers
- Locations
- Divisions of interest
- Eliminated transactions
- Handling of credits and offsets (which method will be used)
- Handling of missing invoices

Should agreement not be possible, the auditor will make the final decision on and be responsible for the sampling characteristics and the sampling methodology. Should agreement be reached and based on the sampling plan, the CAS will complete and provide the necessary documents and/or schedules to the auditor for inclusion in the audit working papers.

Form CDTFA-472, *Use of Sampling in Auditing*, will be used by the auditor (the CAS will assist when necessary) to document the sample selection methodology.

After the electronic data is verified and reconciled, at the request of the auditor, the CAS will:

- Filter the electronic data for selecting the sample or accounts of interest.
- Design statistical sampling plans for appropriate areas of the audit.
- Perform other computer assisted audit procedures as needed.

See AM Chapter 13, section 1305.00, for more information on sample selection and evaluation of sample results.

Exit Conference

As a general rule, the CAS's work will be completed long before the exit conference. Presence of a CAS at the exit conference is not mandatory; however, the DPA or Area Administrator, or Supervising Tax Auditor may request the CAS attend when beneficial

CONTACTS WITH THIRD PARTY REPRESENTATIVES 0403.14

In order to protect the taxpayer, it is always a good practice to secure written authorization from the taxpayer to discuss their case with a third-party representative, preferably prior to initiating any discussion or correspondence with the person claiming to be a representative of the taxpayer. It is, however, not generally necessary to obtain written authorization when the taxpayer introduces or refers the auditor to the representative. It is also not necessary to obtain written authorization when the representative is a professional governed by a code of ethics, e.g., a Certified Public Accountant (CPA) or attorney. However, as stated above, it is a good practice – particularly when contacted unilaterally by a professional – to obtain a written authorization or acknowledge the contact in writing with a copy to the taxpayer. Taxpayers should receive copies of all correspondence between the CDTFA and taxpayer's representative concerning the taxpayer's case(s).

POWER OF ATTORNEY 0403.15

A taxpayer may be represented by legal counsel, Certified Public Accountant (CPA), Enrolled Agent (EA), or other representative. To determine if a power of attorney (POA) has previously been entered into the system, team members may find the link in the Registration tab and Links sub-tab. If the taxpayer filed a POA hard copy, it would be attached to the Customer or Account springboard with a CRM Note entered in the system. If the representative is not in CDTFA's online system, the representative will be directed to submit the request online by accessing CDTFA's Online Services page. The representative may also request third-party delegate access which allows the representative to file returns, make payments, and update account information on behalf of the taxpayer.

The taxpayer's representative will create a username and password in CDTFA's online system. After logging in, the representative selects the POA link, selects the applicable tax or fee program(s), and completes all required fields to submit the request.

The online submission by the representative initiates a letter to the taxpayer and an online message in the taxpayer's portal to either approve or deny the POA request. The online POA request also creates a task in the system. If the taxpayer responds online, the task will be automatically closed. If the taxpayer contacts CDTFA, the team member can manually approve or deny the POA request.

Taxpayers who submit a POA hard copy may use a CDTFA-392, *Power of Attorney*. In lieu of a CDTFA-392, CDTFA will accept any written document identified as a "power of attorney" containing all of the following information:

1. Taxpayer's name, telephone number, identification number(s), account or permit number(s) and mailing address;
2. The name, address (including e-mail, if any), telephone and FAX number of the appointed representative(s);
3. The tax matters the representative is authorized to represent the taxpayer; the scope of the representative's authority; and the tax period(s) for which the authorization is granted;
4. A statement that the power of attorney revokes all prior powers-of-attorney, with any exceptions to the revocation noted;
5. The time period during which the power of attorney shall be in effect; and
6. The signature(s) and title of all affected taxpayers and the date of signature.

Taxpayers who submit a POA hard copy will not have their representative added into CDTFA's online system unless sufficient information to add them was provided. If the representative is already in the system, or is added into the system, they should be linked to the customer or account (see Help Manager instructions for adding the link). The POA hard copy must be attached to the taxpayer's Customer or Account springboard. A CRM Note must be added on the Customer or Account springboard and the representative's contact information must be entered under the Registration tab.

When a taxpayer has submitted a POA appointing a representative, CDTFA team members must work with the representative regarding all tax and fee matters identified in the POA (unless directed otherwise by the taxpayer). However, team members should continue to be responsive to any direct communication from the taxpayer.

All copies of taxpayer correspondence must also be sent to the representative. When a representative is involved with an audit, petition, or claim for refund, the representative will receive copies even though a specific request has not been made. All online correspondence, notices, statements, or reports must also be sent to the taxpayer's representative. If the representative has been linked to the taxpayer in the system, copies of billing notices are sent to the representative automatically. For Appeals letters, a copy will be sent to the representative automatically only if the "cc" box is checked within the Appeals case. For all other letters and notices, team members must manually add the representative as a carbon copy on the Mail springboard, so they receive copies of taxpayer correspondence covered by the POA. The Help Manager in the system contains instructions for adding a copy of a letter.

If the representative has demonstrated a repeated failure to respond to inquiries or requests, especially regarding issues that are time sensitive and require immediate action, team members may, after consulting with a supervisor, contact the taxpayer directly. All actions or correspondence must be fully documented in CRM Notes in the system.

The decision to contact the taxpayer directly should be based on the representative's degree of cooperation with CDTFA and the taxpayer's compliance with CDTFA action(s) that are requested through the representative. All subsequent contacts with the taxpayer and the taxpayer's representative must be fully documented in CRM Notes in the system to protect against potential claims or allegations of harassment. In situations requiring personal contact with the taxpayer, a supervisor or lead person may accompany the team member.

If the taxpayer or their representative has obtained a restraining order forbidding contact by CDTFA, team members must comply with the order. See the CDTFA Manual of Administrative Policy section 7701 for procedures when a restraining order has been filed against CDTFA.

During an audit and whenever warranted, a copy of the written POA must be scanned and attached in the system. In addition, the original POA must be retained in the office file until the audit case is closed. The paper copies of the POA shall be reviewed on an annual basis and confidentially destroyed as provided in AM section 0214.03. If the POA is submitted by the taxpayer using Online Services, no further action is required.

WRITTEN CORRESPONDENCE 0403.18

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

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

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

PRELIMINARY EXAMINATION 0403.20

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

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

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

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

If such preliminary examination of records indicates that substantial portions of the necessary documentation are not available (such as resale certificates), the auditor should advise the taxpayer what further data is needed and postpone starting the audit until this information has been obtained. See AM section 0401.12, *Information Document Requests*, for procedures on requesting records, in writing, when the taxpayer fails to respond to verbal request for the same records. Consideration should be given to securing a *Waiver of Limitation*, Form CDTFA–122. See AM section 0215.15.

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

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

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

On completion of the above, potential areas of under or overstated tax should now begin to form in the auditor's mind.

SPECIAL CONSIDERATION — FIRE OR NATURAL DISASTER 0403.23

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

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

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

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

PRELIMINARY TESTING 0403.25

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

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

- Personnel
- Accounting methods, and
- Types of transactions

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

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

SURVEY OF PLANT 0403.30

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

RECEIPT FOR TAXPAYER'S RECORDS 0403.35

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

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

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

When taxpayer data is in the possession of the CDTFA it will be stored in secure, lockable areas. Thus, taxpayer books and records must be stored in a locked area when the records are not actually being used.

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

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

If the taxpayer does not respond to normal attempts to return the records, a letter should be sent to the taxpayer by certified mail at the address given on Form CDTFA–945. The letter should notify the taxpayer that the records are no longer needed and unless he or she responds or advises the Board within 15 days where to ship the records, the records will be destroyed as authorized by the taxpayer on Form CDTFA–945. To allow an ample margin of time there should be no actual destruction of the records until at least 30 days after mailing the certified letter.

After 30 days, if the taxpayer's records can serve no useful purpose in connection with the tax obligation, they should be removed from the files and disposed of in the same manner as other records the destruction of which has been authorized. A record of such destruction, together with copies of Form CDTFA–945 and the certified letter, should be retained.

AUDIT PROGRAM — PROCEDURE TO FOLLOW 0404.00

PLANNING THE AUDIT 0404.05

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

a. Determine whether the correct amount of tax has been reported; and

b. If not, what is the amount of under or overstated tax.

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

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

a. Direct Audit Approach — auditing the formal accounts and records of the taxpayer.

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

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

a. Establish a test base,

b. Establish test periods, and

c. Come to an understanding with the taxpayer to the extent possible as to:

- Reasonableness of test approach
- Assistance to be furnished by taxpayer in assembling or preparing test data, e.g., sales invoices, vendor's invoices, resale certificates, or EDP runs as necessary

EXPLORATORY TESTING 0404.15

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

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

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

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

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

MAKING THE AUDIT — PROCEDURES AND TECHNIQUES 0405.00

GENERAL 0405.05

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

Some of the special techniques and procedures are:

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

These procedures and techniques are described in the following sections.

AUDITS ON A TAXABLE MEASURE BASIS 0405.10

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

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

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

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

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

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

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

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

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

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

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

- Payments to the California Department of Tax and Fee Administration
- Tax on cash discounts, returned sales or rescinded sales
- Tax refunded due to an overcharge or erroneous charging of tax on an exempt transaction

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

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

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

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

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

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

SHORT TESTS 0405.15

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

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

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

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

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

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

USE OF TEST BASIS 0405.20

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

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

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

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

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

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

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

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

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

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

- The tax has been properly computed and added to taxable invoices.
- The tax so computed has been properly accrued in the sales tax accrual account.
- The tax so accrued had been remitted to the State.
- All exceptions noted will be scheduled and summarized and the disallowed deduction for the entire audit period will be computed.
- If the method used by the taxpayer is to deduct the sum of the taxable sales from total sales and claim the residual amount as a deduction, the auditor should verify the taxable sales only. Any exceptions should be scheduled and a percentage of taxable sales understated should be computed based on the relationship the additional taxable sales bear to total taxable sales reported. The percentage thus computed will be applied to reported taxable sales in all periods other than those listed. Use actual additional taxable sales determined for the test periods. This method is not practical when the taxable sales are very small or when they fluctuate greatly from month to month. In such case, it may be necessary to base the percentage on deductions claimed rather than on taxable sales.
- The procedure under both of these methods is, in effect, auditing on a taxable sales basis (0405.10).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

◦ For example:

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

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

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

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

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

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

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

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

(k) **Analyzing sample results for reasonableness.** The proposed measure resulting from the projection of the sample results must be compared and analyzed for reasonableness by looking at the taxpayer's business as a whole. This type of analysis does not necessarily involve preparing a schedule to evaluate the impact, but the auditor must be alert to indications that the projection of the sample results is possibly unreasonable. If the results appear unreasonable, the auditor must discuss the situation with the taxpayer. The auditor and the taxpayer should come to some agreement as to whether or not the results are representative of the business for the time period in question.

(l) **Missing Documents** — If, during the course of a sample, a document cannot be located, normal auditing procedure requires the auditor to ascertain the reason for the missing or incomplete documents. When the investigation fails to reveal any specific reason, the auditor may first determine whether there is any acceptable alternative evidence. Fortunately, as more and more companies are converting to true paperless systems, it is generally not difficult to obtain a considerable amount of data about a missing invoice. The only statistical requirement is that an audited value be established for each sampling unit.

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

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

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

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

(m) Timing — Auditors must take care to be aware of timing differences between the date of a transaction and the date it is recorded by the taxpayer. For example, paid bills are frequently recorded when paid rather than on the date of the invoice. See subsection titled *Timing — Progress Payments/Installment Contracts*, in section 1303.25 for a discussion of installment payments.

USE OF FORM CDTFA–472, AUDIT SAMPLING PLAN 0405.23

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

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

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

The information and methods documented in this form are not binding on either the taxpayer or Board staff. The sampling plan can and should be continually evaluated (and changed, if necessary) based upon information obtained during the audit process. However, if any deviation from this sampling plan is required, the deviations will be fully explained and discussed with the taxpayer.

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

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

BANK DEPOSITS 0405.25

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

(a) Where records of deposits are available for the entire period, they should be scheduled for that period.

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

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

Increases:

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

Decreases:

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

Other:

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

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

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

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

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

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

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

OBTAINING FINANCIAL INFORMATION 0405.27

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

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

MARK-UP METHODS 0405.30

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

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

USING THIRD-PARTY PROPRIETARY DATA IN AUDITS 0405.32

GENERAL

The CDTFA obtains information about taxpayers from various sources including, but not limited to, other state agencies, businesses, wholesalers, and data houses. Some of this information may include third-party proprietary data that cannot be shared with the taxpayer.

In many industries, a third party compiles data about individuals and companies based on their financial transactions for the purpose of selling the data. "Proprietary data" is the data not owned by the CDTFA and marked by a third-party contractor or provider with restrictive language asserting intellectual property rights. The data, including certain data provided to the CDTFA in a subscription based service, may be copyrighted and distribution is prohibited without the third-party's prior consent.

PROCEDURE

When audit staff relies upon third-party proprietary data in an audit, they must inform the taxpayer they are doing so at the time the audit is being conducted. Audit staff must also provide the taxpayer information (i.e., the third-party source) on where the taxpayer can obtain the data, when available. Staff should document the source of data and the date of the discussion with the taxpayer in the CDTFA-414-Z Program (see AM section 0221.00) and in the audit working papers.

USE OF PRIOR AUDIT PERCENTAGES OF ERROR IN SUBSEQUENT AUDITS 0405.33

The prior audit percentages of error (PAPE) program involves, under certain circumstances, the use of a percentage of error developed in a prior audit for the sales or accounts payable portion in two subsequent audits. Staff must obtain approval from the Deputy Director, Field Operations Department (FOD) to apply a PAPE to the second subsequent audit. The PAPE can be a valuable tool in streamlining the audit process. It is designed to reduce the time it takes to complete an audit and minimize the burden on taxpayers.

When planning the audit, supervisors and auditors should evaluate whether the taxpayer is eligible for the use of a PAPE. This evaluation should be 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 should discuss the PAPE with the taxpayer as soon as possible rather than wait for the taxpayer to request using a PAPE. The date of the discussion and the taxpayer's response should be documented on Form CDTFA-414-Z, *Assignment Activity History*. A decision that the taxpayer is not eligible should also be explained and documented on Form CDTFA-414-Z.

To qualify for the PAPE, the taxpayer must have at least one prior audit and must meet the conditions discussed in this section. The most recent prior audit and the subsequent two audits must indicate consistent operations, volume, and potential type of errors. Limited testing of the taxpayer's records and internal controls will be necessary in order to determine whether there have been any changes to the taxpayer's operations since the last audit. Such testing should include an examination of source documents, such as invoices and paid bills, for changes in processing procedures since the last audit. Other changes to look for include:

(a) Nature of their business

(b) Accounting procedures

(c) Key personnel or turnover of staff

(d) New or revised laws or regulations affecting their business

(e) Significant increases in the population being sampled

If limited testing discloses some change(s) to the taxpayer's operations, the auditor should take into consideration the materiality of the change(s) and whether or not a PAPE can still be used for a portion of the audit period or the area being tested. If the change(s) in the taxpayer's operation is minor, the risk of underestimating the audit results by applying a PAPE may be small. It is important to remember, as noted above, that the use of a PAPE is limited to two subsequent audits and therefore will not create a basis for RTC section 6596 relief in a third subsequent audit.

The techniques used in the prior audit to calculate the PAPE will not preclude its use in the subsequent two audits; however, other factors, as noted above, must be taken into consideration before approving the use of the PAPE in the subsequent two audits.

To be representative, if stratified dollar limitations were used in the last audit, generally the same dollar stratification should be used in the subsequent two audits. If there is an indication during the limited testing that a different stratification level may be appropriate in the subsequent two audits, the percentage of error to apply in the subsequent two audits will be calculated by combining multiple strata from the prior audit. To compute the single percentage of error or a specific area tested in the prior audit, divide the total measure of errors by the population.

For example, if claimed exempt sales were sampled using stratified dollar limitations in the prior audit, the single percentage of error (recomputed PAPE) is the ratio of the total measure of disallowed exempt sales to the total claimed exempt sales, in the prior audit. The total measure of errors (numerator) can be obtained from the audit work papers' lead schedule, the front of Form CDTFA-414-A, Report of Field Audit, or IRIS. The total population of claimed exempt sales (denominator) can be obtained from Form CDTFA-414, Transcript of Return Filed-Sales and Use Tax or in the prior audit work papers. The recomputed PAPE in this example is then applied to the quarterly claimed exempt sales in the subsequent two audit periods, which are generally available on Form CDTFA-414-M.

After discussing the use of a PAPE with an eligible taxpayer(s), a detailed outline memo from the Audit Supervisor to the District Principal Auditor (DPA) or in the case of a second subsequent audit, from the Audit Supervisor to the DPA and Deputy Director, FOD should be prepared for each interested taxpayer indicating why they would make a good candidate for inclusion in this program (Exhibit 5). Each outline should include:

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

The memo outline should be approved by the DPA and in the case of a second subsequent audit the DPA and Deputy Director, FOD, and maintained in the *Memos & Misc. Documents* subfolder of the audit case folder as a memo schedule.

Upon the DPA's and if needed Deputy Director, FOD approval of a PAPE, the DPA (or designee) will enter basic information on the account into the District Reports Data Base (DRD). Basic information includes:

- Account Number
- Case ID
- Taxpayer Name
- Auditor Name
- Industry Type (NAICS)
- Audit Period
- "Area" that PAPE will be applied to
- Approval date by District Principal Auditor

In addition, immediately after the audit has been transmitted to headquarters, the DPA (or designee) will enter the remaining detailed information regarding the outcome of using the PAPE into the District Reports Data Base (DRD). This information will include:

- Tax for "Proposed" PAPE assessment
- Estimated Hours Saved
- Total Audit Hours
- Transmittal date

USE OF SUCCESSOR OR PREDECCESSOR INFORMATION IN AN AUDIT 0405.34

CDTFA employees may access confidential taxpayer information to perform their duties. However, Revenue and Taxation Code (RTC) section 7056, prohibits CDTFA employees from divulging in any manner, whether directly or by inference, to a third party business affairs, operations, or any other information pertaining to any taxpayer.

When a closed-out business retains no books and records for audit, CDTFA auditors may have to use other reliable sources of information to verify the taxpayer's reporting. In some cases, the only reliable source of information available is from the business of the predecessor or successor. CDTFA auditors may use successor information in the audit of the predecessor's business, or vice versa, under either of the following two conditions:

1. The auditor obtains written permission from all parties involved; or
2. The auditor uses the information without divulging the source, whether directly or by inference.

When obtaining permission from both the predecessor and the successor, the auditor must first get written permission from the taxpayer of the business being audited. Once permission is received, the auditor may request written permission from the taxpayer of the other business. This procedure applies even if the predecessor and successor are related, as in a closely-held family business.

> *For example:* if the auditor would like to use a site test of the successor's business in the audit of the predecessor's business, the auditor must first obtain written permission from the predecessor to use this procedure. This is necessary because while engaging the successor for permission, the auditor will disclose, either directly or by inference, to the successor that the predecessor is being audited. Once written permission is received from the predecessor, the auditor must then obtain written permission from the successor to use a site test of its business in the audit of the predecessor.

If obtaining written permission from both the predecessor and the successor is unlikely, staff may not use information from one taxpayer's business in an audit of another business while disclosing the source of the information. Staff should not complete an audit without clear explanation of the basis for the audit result. In situations where taxpayers maintain no books and records, staff must consider other alternative methods, such as the use of industry averages or the prevailing regional averages of similar businesses.

CUT-OFF TECHNIQUES 0405.35

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

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

(a) Expanding the test base by inclusion of additional test periods.

(b) Narrowing the test base because the results do not disclose significant error. For example:

- Cut-off detail examination of certain invoices to examine only those over a given amount.
- Cut-off detail examination of certain invoices to examine only those for certain customers or vendors as the case might be.

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

(a) Materiality of error encountered.

(b) Frequency of error.

(c) Blind alleys:

- Source detail missing.
- Change in filing system.

(d) Discovery of a more efficient approach, e.g., change from invoice testing to an accounts payable examination selection of certain vendors. This will be found to be equally applicable to sales invoices and accounts receivable.

(e) Arrival at an opinion prior to completion of the test as originally planned.

WHOLE DOLLAR AUDITING 0405.40

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

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

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

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

(b) Treatment of variances:

- The sum of whole-dollar amounts will often differ by a few dollars from the sum of the exact amounts. For tax auditing purposes, this is not important since the variance in terms of tax is negligible.
- These small variances (usually less than $5) will be dropped at the first convenient place they can be identified in the working papers. Variance differences standing alone are easily discernible. Variance differences commingled with clerical errors or errors on returns are not easily discernible and need not be dropped.
- An example of a column to eliminate rounding variances in lead schedules is shown in Exhibit 6. In some cases, it is possible to drop readily identifiable variance differences in subsidiary schedules.

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

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

WORKING PAPERS 0405.45

Chapter 3, Audit Working Papers, contains the basic information relating to audit working papers. Usually each portion of an audit, namely, total sales, self consumed merchandise, sales for resale, etc., should be considered as a separate unit with separate working papers for each unit.

MAKING THE AUDIT — APPLYING PROCEDURES AND TECHNIQUES 0406.00

GENERAL 0406.05

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

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

EXAMINATION OF GENERAL LEDGER ACCOUNTS 0406.10

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

EXAMINATION OF GENERAL JOURNAL 0406.15

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

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

EXAMINATION OF CASH RECEIPTS AND DISBURSEMENTS RECORDS 0406.20

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

EXAMINATION OF ACCOUNTS RECEIVABLE LEDGER 0406.25

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

EXAMINATION OF PURCHASE JOURNAL 0406.30

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

SCHEDULE OF TOTAL SALES OR REVENUE 0406.35

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

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

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

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

GROSS PROFIT AND NET WORTH ANALYSIS 0406.40

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

(a) Gross Profit = Sales minus Cost of Goods Sold

(b) Cost of Goods Sold = Gross Profit ÷ by Mark-Up %

(c) Mark-Up Percentage = Gross Profit ÷ Cost of Sales

(d) Gross Profit = Capital Asset increases + Expenses + Withdrawals

(e) Sales = Cost of Goods Sold + Capital Asset increases + Expenses + Withdrawals

The items to be determined are:

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

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

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

MARK-UP BASED ON INCOME TAX RETURNS 0406.45

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

INCOME TAX RETURNS AS BASIS OF AUDIT 0406.50

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

EXAMINATION OF SALES OR REVENUE INVOICES 0406.55

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

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

(a) **Postings.** This is the first step in the verification of the accuracy of the books of original entry. The invoice, sales or revenue, is vouched directly to the sales or revenue journal for accuracy of posting relative to amount and classification in the journal.

(b) **Tax accrual.** On those taxes subject to reimbursement (i.e., sales and use tax), the tax as accrued on the invoice is important for reasons such as:

- Accrual of the tax based on the measure, i.e., sales tax rate times the selling price. This would relate to audits verifying the taxpayer's reporting on an accrual of tax basis, and
- The provisions of Regulation 1700 of the Sales and Use Tax Law concerning excess tax reimbursement.

(c) **Deductions.** At the time the invoice is being reviewed for posting accuracy, etc., it also, will be reviewed for evidence of exemption or non-taxability. For example, if a sale is being claimed as an exempt sale for resale, the resale certificate itself could be examined at that time.

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

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

CONCESSIONAIRES 0406.60

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

(a) Percentage of net or gross sales with possible provision for minimum rental payment

(b) A fixed rental

(c) A profit-sharing arrangement

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

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

SPECIALIZED TECHNIQUES — SALES AND USE TAX 0407.00

GENERAL 0407.05

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

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

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

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

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

MARK-UP METHODS 0407.10

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

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

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

Before proceeding, one other point should be made. Mark-up as previously discussed may be used to determine sales; it may also be used as a short test in examining the mark-up produced by the taxpayer's records. Is this mark-up satisfactory for the type of business involved? If it is, this may satisfy as verification of total sales, etc. This same technique may be used to verify a deduction – for example, sales of food products in a liquor store. See AM section 0407.12.

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

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

(a) The determination of total purchases

(b) The segregation of purchases between departments or types of merchandise having the same general level of mark-up

(c) Self consumed merchandise

(d) Shrinkage of inventory

(e) Inventory adjustments

(f) The computation of mark-up for each department or class of merchandise

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

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

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

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

(a) Drug Stores

- Proprietary drugs (non-prescription)
- Ethical pharmaceuticals
- Drug sundries
- Tobacco products
- Notions, stationery and supplies
- Liquor
- Fountain supplies
- Food products
- Newspapers and magazines

(b) Service Stations and Garages

- Tires and tubes
- Oil
- Grease
- Parts
- Accessories
- Batteries
- Gasoline

(c) Liquor Stores

- Distilled spirits
- Beer
- Wine
- Soda
- Food
- Tobacco products
- Newspapers and magazines
- Other merchandise

(d) Clothing Stores

- Garments
- Accessories
- Shoes
- Miscellaneous merchandise

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(1) Weighted average; purchases of one or more purchasing cycles

(2) Segregation of classes of merchandise

(3) Average of selected items

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

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

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

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

Mark-up = 9,946/15,046 = 66.10%

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

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

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

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

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

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

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

MARK-UP OF COST OF EXEMPT FOOD ITEMS 0407.12

In audits of businesses that only sell a low percentage of exempt food products, it is acceptable to compute a mark-up based on cost-of-goods sold (CGS) for exempt food items where total sales are accepted. This approach may increase audit efficiency for audits of liquor stores, smoke shops, and other similar businesses making minimal exempt sales of food items.

Auditors may use this approach when the review of books and records reveals the overall mark-up is adequate, (i.e., total sales are accepted, recorded purchases are complete, and no posting errors are noted) but, the mark-up on taxable sales is low. To mark-up the cost of exempt food items the auditor should:

1. Conduct a shelf test on exempt sales of food items to determine a food mark-up factor.
2. Perform a purchase segregation, if necessary, to determine a representative audited mark-up.
3. Apply the audited mark-up on CGS for exempt sales of food items to compute audited exempt sales of food products.
4. Compare audited exempt sales of food products to the food exemption claimed.
5. Adjust the claimed food exemption when a material discrepancy exists.

SHORT TESTS 0407.15

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

(a) Small markets or grocery stores:

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

(b) Small service stations and garages:

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

(c) Small retail stores:

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

(d) Small restaurants and lunch stands:

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

(e) Bars:

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

VERIFICATION OF RECORDED TOTAL SALES 0407.20

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

CASH REGISTER SHORTAGES 0407.25

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

1. Sales are rung on the cash register incorrectly, are then re-rung correctly, but the sales clerk fails to cancel (void) the first ring.
   Erroneous duplicate over-rings are allowable as a reduction of sales.

2. Sales are recorded on the register for more than the actual sales amount; for example, a $1.00 item rung on the register as $10.00. The reverse (under-rings) also occur.
   Over-rings and under-rings are to be treated as a reduction or addition to sales recorded on the cash register.

3. Charge sales checks have illegible or missing credit card imprints or handwritten customer names. (These are billed as an unidentifiable receivable and subsequently written off to cash register shortage.)
   Illegible charge sales checks are considered as worthless or uncollectible accounts. Accordingly, such uncollectible sales qualify as a bad debt deduction. However, any amounts which are subsequently collected should be reported.

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

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

6. Charge sales checks indicated by sales person as cash and therefore never billed to the customer.
   These are considered to be worthless accounts similar to items 3 and 4.

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

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

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

PURCHASES SUBJECT TO SALES OR USE TAX 0408.00

GENERAL 0408.05

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

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

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

METHODS OF VERIFICATION 0408.10

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

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

AUDITS OF SALES SUBJECT TO USE TAX 0408.12

In determining the party liable for the assessment of use tax, the auditor should not presume the use tax will be assessed in the future audit of a purchaser due to the size of the entity or audit history, and may assess use tax against the seller. To avoid a duplicate assessment of use tax on the same transaction, the auditor should complete Form CDTFA-1164, *Memorandum of Possible Tax Liability*, as provided in AM section 0408.18 and make a notation whether use tax was assessed on the seller/purchaser. The auditor sends a copy of the form to both taxpayer files. In addition, the auditor may preclude the duplicate assessment of use tax by using Form CDTFA 503-C (paper version) or Form CDTFA-503-C1 (electronic version), S*tatement of Property Purchased Without Payment of California Use Tax.*

Generally, in a simultaneous audit of the seller and purchaser, the use tax is assessed in the audit of the purchaser. However, the auditor should verify tax is not being assessed in the audit of the seller to avoid double taxation of the transaction. The auditor should adhere to the guidelines outlined in AM section 1302.25 when the transaction relates to a statistical sample.

When an auditor determines there is a potential use tax liability, the auditor must determine whether use tax on a transaction was already paid by a different taxpayer. Auditors can determine whether use tax was already paid by examining:

- ABC Letters – used to verify payment of use tax by out-of-state sellers
- IRIS – utilize IRIS screens to determine if the purchaser is registered with the CDTFA (generally this is done using jump code CTS CS) and if any use tax was remitted
- Audit Archive – digitalized copies of working papers available on the network
- California state income tax return (to verify purchaser reported purchases subject to use tax on their income tax return)
- XYZ Letter

While these steps must be taken to ensure tax is not asserted more than once on a single transaction, auditors must also maintain the confidential nature of CDTFA's information and not disclose to the taxpayer that the other party is under audit or that CDTFA intends to examine the records of the other party. To ensure confidentiality, auditors should only comment in the audit working papers that "tax has otherwise been paid." A reference to the permit number is acceptable because it does not imply an audit is being conducted. However, no further information should be noted, other than the permit number.

Out-of-state retailers are required to register and collect use tax on sales made to customers in this state if they are "engaged in business" in this state. If the out-of-state sellers cannot be found in the system, it is likely they are not registered with CDTFA and auditors are to prepare a CDTFA-1164, *Audit Memorandum of Possible Tax Liability*, form as provided in section 0408.19.

The following are examples of transactions in which auditors need to verify whether use tax was paid by or assessed in the audit of the corresponding purchaser or seller.

Example 1: Audit of a registered out-of-state seller discloses a questioned ex-tax sale to an unregistered purchaser.

> After exhausting the examination steps above (for example, allowing the seller to send XYZ letters), the auditor should disallow the questioned ex-tax sale if it cannot be determined that use tax was paid or the transaction was not subject to tax.

Example 2: Audit of the purchaser discloses a questioned ex-tax purchase from a registered out-of-state seller.

> When the auditor establishes the seller is registered with CDTFA with a seller's permit or a certificate of registration for use tax, auditors should use the system (New Manager, Search, Search) (Account springboard, Financial, Returns. Select the link for each return in the audit period then select the link for Form 401-A2 to see details on line 2 of each return) to determine whether the questioned transaction occurred during an audit of the seller.
>
> If the transaction does occur within an audit period of the seller, then the auditor should determine if any use tax assessment was made against the seller. This can be done by:
>
> - Contacting the auditor of the seller directly and/or
> - Reviewing the audit in the Audit Archive or in the system

If it is determined use tax was assessed in the audit of the seller, the auditor should comment "tax has otherwise been paid." If the transaction does not occur within an audit period the auditor should exhaust the steps above to determine if use tax was otherwise reported by the seller (for example, allowing the taxpayer to send ABC letter). If use tax was not reported by the seller, the auditor should assess use tax against the purchaser.

Example 3: A block sample used to test sales subject to use tax in an audit of a registered out-of-state seller.

A questioned ex-tax sale of $1,000 was found in the audit of the registered out-of-state seller and determined to be taxable. The auditor of the seller noted that the purchaser is registered with CDTFA and the transaction was included within the audit period of the purchaser. The auditor of the seller contacted the auditor of the purchaser and determined a block sample was performed on ex-tax purchases with the following results:

- Population – 5,500 transactions (includes the $1,000 transaction questioned above)
- Block test period – one quarter (invoices were readily available)
- Projected error of $65,000

The auditor of the seller should allow the questioned ex-tax sale. The transaction was included within the audit period of the purchaser and tax was projected on that population of sales. The questioned ex-tax sale does not need to be one of the sample items selected in the test. If the projection of error reasonably covers the questioned transaction, the auditor should allow the questioned ex-tax sale because the tax was ultimately assessed against the purchaser.

Example 4: A statistical sample used to test sales subject to use tax in the audit of the purchaser.

A questioned ex-tax purchase of $1,500 was found in the audit of the purchaser and determined to be taxable. The auditor of the purchaser noted the seller was registered at an out-of-state location, and the transaction fell within the audit period of the seller. The purchaser did not issue an exemption certificate or resale certificate to the seller. The auditor of the purchaser contacted the auditor of the seller and determined a stratified statistical sample was performed on ex-tax sales with the following results:

- Strata 1 ($0.00 - $999.99) – Projected error of $175,000
- Strata 2 ($1,000 - $4,999.99) – Projected error of $348,000
- Strata 3 ($5,000 - $19,999.99) – No projection of error (No errors found in sample)
- Strata 4 ($20,000+ Actual Basis) - $233,000

The auditor of the purchaser should allow the questioned ex-tax purchase. The transaction was included within the audit period of the seller and tax was projected on the strata containing the questioned transaction. The questioned ex-tax purchase does not need to be one of the sample items selected in the strata. If the projection of error reasonably covers the questioned transaction, the auditor should allow the questioned ex-tax purchase.

Note: If there was no projection of error made for Strata 2, the auditor of the purchaser should **not** allow the questioned ex-tax purchase (unless other evidence points to the contrary) because under those circumstances it is likely that tax was not assessed in the audit of the seller.

EXAMINATION OF PURCHASE INVOICES 0408.15

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

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

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

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

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

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

USE OF FORM CDTFAFA–503, “ABC” LETTER PROCEDURE 0408.16

The taxpayer may be able to prove that the questioned items were not subject to tax; or were reported in another reporting period; or the tax was paid by the vendor on their tax return or audit determination. To assist the taxpayer in satisfying their use tax obligation, the CDTFA has developed the Form CDTFA–503 – ABC Letter Procedure (hereafter called “ABC” Letter). (See Exhibit 7)

The “ABC” Letter procedure utilizes the following form set:

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

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

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

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

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

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

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

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

ASSERTION OF USE TAX ON LEASES 0408.17

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

An exception to the above general policy is that tax may be assessed against the lessee if the lessor is located out-of-state, and the property being leased is not mobile transportation equipment (MTE). If tax is assessed, Form CDTFA–1164 should be sent to the lessor's district showing the amount of tax assessed and the applicable periods.

As a note, the California Sales and Use Tax Law does not provide an exemption from sales or use tax for sales made to California governmental agencies(RTC section 6005). This provision also applies to out-of-state sellers and lessors who make sales or leases to California governmental agencies. In such case, the registered out-of-state retailer should collect and report the California use tax.

USE OF FORM CDTFA–1164, AUDIT MEMORANDUM OF POSSIBLE TAX LIABILITY 0408.18

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

The auditor should also prepare Form CDTFA–1164 if in the examination of sales invoices, the auditor finds that the seller did not charge tax and has accepted a properly executed resale or exemption certificate in good faith and the auditor questions whether the buyer has in fact purchased the merchandise for resale or in fact an exemption applies. The auditor should mark the block "Seller has valid (resale) (exemption) certificate from buyer on file." *The auditor must also include a copy of that certificate with the Form CDTFA–1164.*

Use of Form CDTFA–1164, Audit Memorandum of Possible Tax Liability (Cont.) 0408.18

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 merchants which are discovered during audits of California sellers should be disallowed against the seller (see Publication 32, *Tax Tips for Sales to Purchasers from Mexico*, for an explanation of the Mexican merchant program). However, the auditor should prepare Form CDTFA–1164 for such sales. The form should identify the purchaser and describe the merchandise purchased. The completed form should be sent to the San Diego District Office for its information in monitoring and administering the Mexican merchant program and taking possible action against any merchants who abuse the program (AM section 0409.50).

See AM section 0401.02 for information on confidentiality of Form CDTFA–1164.

INFORMATION ON OUT-OF-STATE RETAILERS 0408.19

Out-of-state retailers "engaged in business in this state" are required to register and collect use tax on taxable sales made to consumers in this state. RTC section 6203 provides that "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 room 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.
- As respects a lease, any retailer deriving rentals from a lease of tangible personal property situated in this state.
- Any retailer that is a member of a commonly controlled group, as defined in section 25105, and is a member of a combined reporting group, as defined in paragraph (3) of subdivision (b) of section 25106.5 of Title 18 of the California Code of Regulations, that includes another member of the retailer's commonly controlled group that, pursuant to an agreement with or in cooperation with the retailer, performs services in this state in connection with tangible personal property to be sold by the retailer, including, but not limited to, design and development of tangible personal property sold by the retailer, or the solicitation of sales of tangible personal property on behalf of the retailer.
- 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 Web site, or otherwise, provided that certain conditions are met.

Auditors should be alert to recognizing and reporting interstate retail sales by persons who are not collecting the tax. When an auditor discovers that a taxpayer is making taxable purchases from an unregistered out-of-state vendor without tax, the auditor should advise Out-of-State District Compliance, using Form CDTFA–1164 (Exhibit 2).

Form CDTFA–1164 is helpful in the proper registration of out-of-state vendors who are engaged in business in California. A separate Form CDTFA–1164 must be prepared for each vendor. It is incorrect to attach a schedule for all vendors to one Form CDTFA–1164. The buyer's and out-of-state retailer's information must be completed on all Form CDTFA–1164s along with all other information. However, copies of invoices and a schedule listing all invoices can be attached to Form CDTFA–1164 for each vendor instead of preparing multiple Form CDTFA–1164s for each of the vendor's invoices. It is emphasized that a copy of the invoice and schedule of purchases may not serve as a substitute for completing the actual Form CDTFA–1164 (except for invoice date, number, and item description, and amount of use tax reported or included in audit). Additionally, it is stressed that a copy of the invoice and copy of the paid bill schedule is the best information to attach to the Form CDTFA–1164. Auditors must make sure the complete address, including the zip code, is noted on Form CDTFA–1164. Without a complete mailing address, it is extremely time consuming and often impossible for Out-of-State District Compliance to properly identify the vendor for correspondence regarding possible registration.

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

Information required on Form CDTFA–1164 for out-of-state retailers includes:

a. Name and address of out-of-state retailer.

b. Name and address of sales representative.

c. Name and address of customer.

d. Invoice number.

e. Date of invoice.

f. Amount of invoice.

g. Description of property sold.

h. How sale was solicited.

i. Any other relevant information concerning seller, sales representative, scope of sales, etc.

In completing Form CDTFA–1164 for out-of-state retailers, the importance of items (a), (b), (h) and (i) cannot be over emphasized. This information should be obtained, if at all possible, in order to enable Out-of-State District Compliance to determine whether an out-of-state retailer should, in fact, be registered despite a contention made that it is not "engaged in business" in the state.

CDTFA-1164 FILE AND FOLDER NAMES 0408.20

Use the following naming convention for CDTFA-1164s:

To District Code_Vendor/Purchaser or Account Number_Audit Case #_CDTFA-1164
(If no account number type in the Vendor/Purchaser Name)

The audit case number refers to the case from which the lead was generated. This is needed in the folder name since there may be cases where a district may send two separate CDTFA-1164s for the same vendor/purchaser. Without a unique designator in the filename such as an audit case ID, Windows will over-write the previous folder.

CDTFA- 1164 File and Folder Names (Cont.) 0408.20

A folder and file need to be created for each vendor/purchaser under the subfolder of CDTFA-1164. Copies of the invoices and supporting documentation should also be included and saved as a file. Supporting documents can be scanned in one file instead of separate files.

CDTFA 1164 – If the vendor/seller has a seller's permit with CDTFA

Filename	Description
AS_013987654_54321_CDTFA 1164.pdf (This is the actual 1164)	Only one sheet is required for each vendor.
AS_013987654_54321_SupportDoc1.(xls or pdf) (supporting document)	A filtered listing of the transactions by vendor from the audit work papers is acceptable.
AS_013987654_54321_SupportDoc2.(xls or pdf) (supporting document)	Scanned resale cards, invoices etc. if needed.

CDTFA 1164 – If the vendor/seller does not have a seller's permit with CDTFA

Filename	Description
AS_ZYXW_54321_CDTFA 1164.pdf (This is the actual 1164)	Only one sheet is required for each vendor.
AS_ZYXW_54321_SupportDoc1.(xls or pdf) (supporting document)	A filtered listing of the transactions by vendor from the audit work papers is acceptable.
AS_ZYXW_54321_SupportDoc2.(xls or pdf) (supporting document)	Scanned resale cards, invoices etc. if needed

CDTFA-1164s For Unregistered Out-of-State Retailers

CDTFA-1164s prepared for unregistered out-of-state vendors will be placed in a separate folder with the following name:

OH_Unregistered_Audit Case #_CDTFA 1164

CDTFA-1164 File and Folder Names (CONT.) 0408.20

A copy of each completed form CDTFA-1164 and supporting documentation will be placed in the OH_Unregistered_Audit Case #_CDTFA 1164 folder using the following name:

Vendor Name_CDTFA 1164
Vendor Name_Support

The Excel Audit Program has a feature that allows auditors to print all CDTFA-1164s into an Access database which in turn can be converted into one PDF file. While this feature is beneficial in creating a batch of CDTFA-1164s all at once, a separate PDF is required for each CDTFA-1164 form. This allows the Out-of-State compliance staff to import each CDTFA-1164 into a database for ease of reference. Auditors may use the Excel Audit Program to generate all CDTFA-s, however they must use the Print-to-PDF feature to isolate each CDTFA-1164 form into a separate PDF. This requirement also applies to supporting documentation such as purchase invoices.

*****Please Note:** All CDTFA-1164s for unregistered out-of-state retailers must be in PDF format. Because the database used to maintain these files cannot upload Excel files, **no** Excel files should be provided to OH.

PROCESSING THE CDTFA-1164 0408.21

When the audit is complete, either the district reviewer or audit control will forward all CDTFA-1164s to the appropriate *_Transfer Documents to Other Districts* folder located on the J:\ drive.

All CDTFA-1164s for unregistered out-of-state retailers go to the *OH_Unregistered_1164* folder only. If the out-of-state retailer is registered and has a permit number, a regular CDTFA-1164 should be prepared and forwarded to the appropriate out-of-state office.

Copies of the CDTFA-1164s are not to be retained in the audit case folder. These files should be deleted when sent to the appropriate office. It will be the district office's responsibility to process and distribute incoming CDTFA-1164s. The files may be left in the *_Transfer Documents to Other Districts* folder, however it is recommended that a separate folder be created on the district drive to store incoming CDTFA-1164s that have not been processed or distributed.

CALIFORNIA USE TAX COLLECTIONS BY UNREGISTERED OUT-OF-STATE RETAILERS 0408.23

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

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

EXAMINATION OF SELECTED GENERAL LEDGER ACCOUNTS 0408.25

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

Asset Accounts	**Expense Accounts**
Delivery Equipment	Advertising
Furniture and Fixtures	Donations
Inter-Company Accounts	Expendable Tools
Leasehold Improvements	Experimental and Exploration
Machinery and Equipment	Manufacturing Expense
Nonexpendable Tools	Repairs
Work in Progress	Research and Development
Supplies	
Samples	
Promotional	

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

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

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

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

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

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

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

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

OTHER RECORDS 0408.27

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

CAPITALIZATION OF RESALE INVENTORY 0408.28

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

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

EXAMINATIONS OF JOURNAL ENTRIES AND REQUISITIONS 0408.30

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

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

EXAMINATIONS OF JOURNAL ENTRIES AND REQUISITIONS 0408.30

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

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

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

FUNGIBLE GOODS 0408.35

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

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

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

USE OR LOAN OF PROPERTY PURCHASED FOR RESALE 0408.40

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

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

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

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

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

AUDITS OF PURCHASES SUBJECT TO USE TAX IN-STATE SERVICE PROGRAM 0408.45

GENERAL

The In-State Service program is administered by the Use Tax Administration Section, In-State Service Group (ISS Group) and was implemented under the tax gap initiative. The tax gap is the difference between the amount of taxes owed and the amount of taxes paid to the state. The tax gap initiative was intended to promote voluntary compliance through education and outreach, implementation of new programs, and improvement of current programs. The purpose of the In-State Service program is to investigate and collect use tax from service based businesses that may not be aware of their reporting requirements. The ISS Group has teams located in Northern California (MIC: 05) and Southern California (MIC: EHS).

Through a monthly letter mailing campaign, the ISS Group contacts in-state service business leads, requiring the business to: conduct a self-review of purchase records for a three-year period; register, file, and pay online any use tax due; and submit supporting documentation for review and verification that the correct amount of use tax was self-assessed.

SOURCE OF INFORMATION

The Employment Development Department (EDD) and Franchise Tax Board (FTB) provide information to the Data Analysis Section (DAS) to help identify service businesses operating in California. The type of information received includes the following: business name, address, phone number, NAICS code, business description, number of employees in California, entity type, FEIN, SSN, gross receipts, and cost of goods sold.

The DAS matches the business lead data to CDTFA records and removes any leads currently registered with a sales or use tax account. The DAS forwards the remaining unregistered in-state service business leads to the ISS Group for further analysis, pre-screening, and selection of leads to assign to staff.

LEAD SOURCE CODES

To capture and identify the revenue resulting from the ISS Group efforts, the Lead Source code **TGI (**Tax Gap In-State Service) is assigned to any sales and use tax accounts generated, any audit cases created, and any compliance assessments issued as a result of the ISS Group efforts.

For new accounts, the Lead Source Sub-type code **EDC** (UTAS EDD Lead) will be assigned. For audit cases, the Lead Source Sub-type assigned depends upon the specific office receiving and conducting the audit. For example, an audit case generated and referred by the ISS Group to the San Diego Office (FH) will have the lead source "TGI FHC" assigned. (FHC = San Diego audit referral from UTAS—ISS Group).

The Lead Source added at the account level will be for three years, by using the creation date of the account for the lead source "start-date" and creation date plus three years for the lead source "end-date."

The Lead Source assigned for Audit Cases or Compliance Assessments should be added directly to the FO (Financial Obligation). Lead source "start date" and "end date" are not required when assigning a Lead Source to an FO.

(See AM section 0103.25, IRIS *Lead Source*, for additional information.)

RESPONSIBILITY OF THE USE TAX ADMINISTRATION SECTION IN-STATE SERVICE GROUP

Initial Contact

Based on the lead data received from DAS, the ISS Group selects and assigns leads to staff to investigate and determine if the in-state service business has use tax that may be due. Initial contact is made to the in-state service business by sending a *Tax Gap In-State Service Contact Letter* (CDTFA-403-CL) that explains what use tax is, how use tax may apply to its purchases, and how to comply with the California Use Tax laws. Included with the contact letter is the *California Use Tax Worksheet* (CDTFA-403-CLW) used to calculate use tax due for the previous three calendar years and verify ownership of the business entity. The letter also references publication 110, *California Use Tax Basics*, and publication 217, *Use Tax Guide to Reporting Out-of-State Purchases*.

If tax is due, the letter and worksheet instruct the business to utilize the CDTFA's online services to register for a use tax account and file and pay the use tax returns. All businesses contacted are required to complete and return the CDTFA-403-CLW, regardless of whether or not they owe use tax, along with the following required documents: purchase journal/general ledger for the past year, a current asset depreciation schedule/asset listing, and their California Income Tax Schedule R, if applicable.

The in-state service businesses have 30 days to respond to the contact letter. After 15 days, staff in the ISS Group will call to verify the initial contact letter was received and to answer any questions the business may have. If a response to the letter is not received within 45 days from the inquiry date, a follow-up letter will be sent to the business.

Desk Review

Based on the contact letter responses, the ISS Group will conduct a desk review of the information provided for accuracy and understanding of use tax, and may do one or more of the following:

1. Assist in filing returns online for previously unreported use tax liability periods.
2. Place a delinquency withhold in IRIS and corresponding comments in IRIS and ACMS for any periods that require additional time to review or require additional assistance.
3. Request additional documents (for example, specific invoices or federal income tax returns).
4. Create Compliance Assessments based on the completed *Use Tax Return Worksheets* and evidence of use tax due found within the required documents received or from other sources.
5. Issue account numbers for future reporting, for those who failed to register but provided information that shows they owe use tax.
6. Refer the ISS Group leads to field audit staff for further investigation if it has been determined that additional use tax may be due or other questionable activities are noted.
7. Close the assignments if no account number (i.e., arbitrary or permanent) is required and no use tax is due.
8. Refer leads on unregistered in-state vendors selling to an ISS Group business to field compliance staff using a CDTFA-142, *District Office Investigation Request*.
9. Refer leads on registered, questionable vendors to field audit staff for further investigation.
10. Refer leads on unregistered out-of-state vendors selling to ISS Group business to the OH 1032 team.

When a service business does not respond within 30 days from the follow-up contact letter date, the ISS Group will further investigate/research the business to determine if the address is valid, business is still active, and whether or not there is a potential for use tax based upon the business industry.

The ISS Group investigates the unresponsive business by doing one or more of the following:

1. Locate business websites, perform internet searches, or conduct searches in the CLEAR system.
2. View state income tax returns requested using the CDTFA-1144, *Official Request for Return Information*, interagency information requested from, EDD, FTB and the Secretary of State which are tracked in the external Agency Tracking system (EATS).
3. Perform a like-business analysis for use tax potential.
4. Cross reference other sources of information for potential for use tax (e.g., customs import documents, request to County Assessor for CDTFA-571-L, *Business Property Statement,* purchase history from known out-of-state vendors used).

Depending on the results from the additional investigation/research of the unresponsive business, the ISS Group will do one or more of the following:

1. Resend the Initial Letter, *if a better address was found.*
2. Make contact with the business/responsible person to further explain use tax and request the business respond to the initial letter immediately.
3. Create Compliance Assessments based on evidence of use tax due from Customs import documents or actual purchase information from out of state vendors.
4. Refer the use tax lead to field audit staff for audit.
5. Close the assignment if business is inactive or if it is determined that the assignment is not cost effective to pursue.

AUDITS OF REFERRALS FROM THE ISS GROUP SALES AND USE TAX PROGRAM

Depending on the response from the in-state service business, the ISS Group will select the leads to be referred for audit, create an account, create an audit case ID using the audit selection reason code GAP, and assign the lead source TGI and the appropriate lead source sub-type to identify the specific office conducting the audit.

Audit referrals are sent electronically and should include:

1. Memo or the ISS Group "all-in-one referral form;"
2. Business lead contact information and business description;
3. Detailed reason for the audit recommendation;
4. Evidence of use tax owed and/or supporting information of potential use tax owed;
5. Any transcribed income tax information, including gross receipts, COGS, assets, and other deductions;
6. Prior contact history between the ISS Group and the business (case history);
7. Copies of letters sent; and
8. Any other relevant information.

For audit tracking purposes, the ISS Group issues arbitrary account numbers to businesses that do not have an account with the CDTFA or did not obtain one during the desk review process. The audit case will be created on the arbitrary account. The ISS Group will conduct periodic follow-ups with the specific offices to determine the status of in-process audits referred to them.

The audit period for these use tax audits will be the prior three calendar years unless otherwise determined by the Principal Auditor or designee. The ISS Group's initial investigation requests the in-state service business review its records and self-report purchases subject to use tax that it made during the prior three calendar years. Despite the three calendar year timeframe, in cases where the in-state service business did not file a return, Revenue and Taxation Code section 6487 authorizes the CDTFA to mail notices of determination within eight years of the relevant period for which it proposes the amount to be determined.

The ISS Group adds the Lead Source code **TGI** and the respective Offices' Lead Source sub-type code to the account and FO at the time the leads are selected for audit and the FO is created for the audit period. The Lead Source and Lead Source Sub-type code are assigned to an account and FO by accessing the LSR ML, *Maintain/Inquire Lead Source Information*, screen in IRIS.

Audit staff performs audits on the use tax leads referred by the ISS Group to determine if use tax may be due. The appropriate CDTFA-80-TG series "Audit Engagement Letter" for the In-State Service Businesses Tax Gap Program should be used to confirm audit engagements or to establish contact.

- CDTFA-80-ATG, *Audit Engagement Letter - Confirm Start Date.*
- CDTFA-80-BTG, *Audit Engagement Letter - Agreement to Delay Start Date.*
- CDTFA-80-CTG, *Audit Engagement Letter - Initiate Contact.*
- CDTFA-80-DTG, *Audit Engagement Letter - 10-Day Follow Up.*

The CDTFA-80-ATG, CDTFA-80-BTG, and the CDTFA-80-CTG include links to the following publications and provide taxpayers with the CDTFA website address so they can download the publications. For taxpayers who are unable to download the publications, information is provided on how to obtain them from the Customer Service Center:

- Publication 70, *Understanding Your Rights as a California Taxpayer*
- Publication 76, *Audits*
- Publication 17, *Appeals Procedures, Sales and Use Taxes and Special Taxes*
- Publication 123, *California Businesses: How to Identify California Use Tax Due*

Audits will be conducted following general audit procedures set forth in this Chapter.

Audit staff should advise the Western States Office (OH) compliance staff, using the CDTFA-1164, *Audit Memorandum of Possible Tax Liability,* when an auditor discovers a business purchasing items subject to use tax from an unregistered, out-of-state retailer (see AM section 0408.19). A notation, "In-State Service Tax Gap" should be written in the comments and recommendation section of the CDTFA-1164 as a flag to the OH compliance staff that this referral was generated from an audit of an In-State Service Business lead. This will assist OH compliance staff in properly identifying and registering out-of-state retailers who are engaged in business in California resulting from TGI efforts. Alternately, audit staff may provide a list of unregistered out-of-state vendors discovered during the audit to the ISS Group, who will ensure the vendors are properly flagged and referred to OH.

Audit staff should be alert to recognizing transactions where the in-state business is remitting California use tax to an out-of-state unregistered retailer who is not billing the in-state business for the use tax. Auditors should utilize the IRIS CTS CS, *Client Search/Registration*, screen to determine whether such out-of-state vendors are registered to collect the use tax. When an auditor discovers that an in-state business is erroneously paying use tax to an unregistered out-of-state retailer, the auditor should immediately advise OH Compliance staff (see AM section 0408.23). The business should be informed of the responsibility for the payment of tax to the proper authority per Regulation 1685, *Payment of Tax by Purchasers.*

Audit Supervisors will follow the normal audit procedures when processing completed audits. The Audit Supervisor should also provide the ISS Group feedback as to the quality of the use tax leads received and suggestions for improvement. This can be done via e-mail to the referring ISS Group Supervisor.

1032 REFERRALS TO WESTERN STATES (OH) OFFICE

The ISS Group will review invoices, worksheets, purchase journals, and asset listings received from all ISS business leads and identify unregistered out-of-state vendors.

Utilizing the 1032 Desktop Application Program (1032 Database) that contains historical data of out-of-state vendors contacted by the CDTFA, the ISS Group will determine if the unregistered out-of-state vendor qualifies as a 1032 referral. If the vendor qualifies, the ISS Group will do the following:

1. Add the vendor to the 1032 Database to create a case.
2. Upload the source document with the vendor's address to the new case.
3. Research the vendor for possible proof of nexus and upload any relevant information.
4. Add the customer information to the case.
5. Add comments to the case and refer electronically to OH Office-1032 team via the 1032 Database.

The appropriate lead source code will automatically populate on the 1032 case for the appropriate UTAS program (ISS or Interstate Commerce Analysis Team (ICAT)). In the case of 1032 referrals from the ISS Group, the lead source is TGI OHE (OHE = OH Office 1032 referral).

SPECIAL TAX AND FEE PROGRAM REFERRALS

There may be occurrences when the ISS Group or the in-state office audit staff determine in-state service businesses are purchasing items from outside of California for consumption and are not being charged appropriate special taxes or fees (for example, purchases of new televisions, computer monitors, portable DVD players, tires, fuel, lead-acid batteries, alcoholic beverages and cigarette or tobacco products). Similarly, there may be cases where OH compliance staff register out-of-state retailers who are engaged in business in California that also require registration under special tax and fee programs.

In such cases, the ISS Group Supervisor, Principal Auditor, OH Compliance Supervisor, or a respective designee, should send an email notification containing the name, address and telephone number of the in-state service business or out-of-state retailer to the "**BTFD-ISS Referrals**" mailbox. The email notification should also include an account number and information concerning the description of items purchased, the quantity of items purchased and the periods in which the purchases occurred, if available. The Registration and Licensing Section will review the notification and forward the information to the appropriate staff for further investigation.

AUDITS OF PURCHASES SUBJECT TO USE TAX
OUT OF STATE VEHICLE, VESSEL, OR AIRCRAFT PURCHASE 0408.50

A purchaser is generally liable for the use tax for a vehicle, vessel or aircraft purchased outside California if the first functional use of the vehicle, vessel or aircraft is in California. Revenue and Taxation Code section 6248 and Regulation 1620, *Interstate and Foreign Commerce*, subdivision (b)(5)(A), provide in part, that when a vehicle, vessel, or aircraft is purchased outside of California, is first functionally used outside of California and is brought into California within 12 months from the date of its purchase, it is rebuttably presumed to have been acquired for storage, use or other consumption in California and subject to use tax if *any* of the following occur:

1. The vehicle, vessel, or aircraft was purchased by a California resident as defined in section 516 of the California Vehicle Code (a closely held corporation or limited liability company shall also be considered a California resident if 50 percent or more of the shares or membership interests are held by shareholders or members who are California residents as defined in Section 516 of the Vehicle Code), or
2. In the case of a vehicle, the vehicle was subject to registration under Chapter 1 (commencing with section 4000) of Division 3 of the Vehicle Code during the first 12 months of ownership, or
3. In the case of a vessel or aircraft, the vessel or aircraft was subject to property tax in this state during the first 12 months of ownership, or
4. If purchased by a nonresident of California, the vehicle, vessel, or aircraft was used or stored in California more than one-half of the time during the first 12 months of ownership.

If any of these factors are present, the presumption will apply regardless of when the vehicle, vessel, or aircraft is brought into California during the first 12 months of ownership.

The first paragraph of Regulation 1620 subdivision (b)(5)(B) provides general guidelines for rebutting the presumption created by Regulation 1620 subdivision (b)(5)(A). It provides that the presumption may be rebutted by documentary evidence demonstrating that the vehicle, vessel, or aircraft was purchased for use outside of California during the first 12 months of ownership. Although the paragraph does not provide a bright line test with set parameters, it requires that all relevant evidence and facts be considered when determining whether the vehicle, vessel, or aircraft was purchased for use outside of California during the first 12 months of ownership. Evidence and facts that may be evaluated and considered include, but are not limited to:

- Whether the vehicle, vessel, or aircraft was previously registered with the proper authorities outside of this state;
- Whether the purchaser had a residence outside this state;
- How the vehicle, vessel, or aircraft was used during the first 12 months of ownership;
- The location that the vehicle, vessel, or aircraft was insured for;
- Whether the purchaser's move to California (if applicable) was voluntary or involuntary; and
- For documented vessels and aircraft, payment of property tax in another state.

Audits of Purchases Subject to Use Tax
Out of State Vehicle, Vessel, or Aircraft Purchase 0408.50

If the evidence and facts demonstrate that, at the time of the purchase, it was more likely than not that the purchaser had no intention that the vehicle, vessel, or aircraft would be used in California, then this alone is sufficient to establish that it was purchased for use outside of California.

The facts and circumstances of each case should be evaluated and considered in their entirety when determining if a vehicle, vessel or aircraft was purchased for use outside of California during the first 12 months of ownership pursuant to the first paragraph of Regulation 1620, subdivision (b)(5)(B). For example, the fact that a purchaser voluntarily moves to California within 12 months of the purchase date does not automatically prevent the purchaser from overcoming the presumption. Instead, a voluntary move is a factor to consider, along with all of the other facts and circumstances, when determining whether a vehicle, vessel or aircraft was purchased for use outside of California. On the other hand, an involuntary move based on circumstances that arose after the purchase date is strong evidence that the vehicle, vessel or aircraft was purchased for use outside the state.

If the evidence provided shows that a vehicle, vessel, or aircraft was purchased for use outside California, then a Certificate of Use Tax Clearance (CDTFA-111) should be issued.

In addition, the second paragraph of Regulation 1620 subdivision (b)(5)(B) and subdivisions (b)(5)(C) and (D) further explain how the presumption may be overcome in certain circumstances involving certain warranty or repair service, retrofits, modifications, and uses in interstate or foreign commerce.

AUDIT OF SALES FOR RESALE 0409.00

GENERAL 0409.05

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

METHODS OF REPORTING RESALES 0409.10

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

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

DEDUCTION SUPPORTED BY ACTUAL LISTS 0409.15

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

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

DEDUCTION CALCULATED 0409.20

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

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

DEDUCTION ESTIMATED 0409.28

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

SELECTION OF THE BASIS FOR THE AUDIT 0409.30

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

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

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

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

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

DETAILED AUDIT — LIST OF CLAIMED RESALES AVAILABLE 0409.35

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

(a) The sales invoices should be examined to determine that the claimed amounts are included in total sales and that the correct amounts have been scheduled. It should be verified that the amounts claimed do not include nontaxable items (delivery charges, labor, etc.) claimed under some other classification, and that no part of the invoice represents a taxable sale.

(b) Documentary evidence of the nontaxability of the sales, such as resale certificates, purchase orders, correspondence, or contracts should be examined. Purchase order, correspondence or contracts may, also, support a finding that a claimed sale for resale is taxable notwithstanding the fact that a resale certificate is on file (section 0409.50).

(c) The nature of transactions and the type and number of items purchased should be scrutinized to determine whether resale certificates (section 0409.55) appear to have been taken in good faith.

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

DETAILED AUDIT — LIST OF CLAIMED RESALES NOT AVAILABLE 0409.40

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

EFFECT OF "CONTRA" ITEMS ON DEDUCTIONS FOR SALES FOR RESALE 0409.45

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

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

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

ACCEPTABLE DOCUMENTARY EVIDENCE TO SUPPORT SALES FOR RESALE 0409.50

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

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

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

Documents that qualify as a valid resale certificate include:

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

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

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

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

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

- Personal knowledge of the auditor gained from audits of the vendees or other sources that the purchase was actually made for resale purposes.
- A satisfactory response to a Form CDTFA–504 (XYZ letter) inquiry (See AM sections 0405.20(j) and 0409.51, and AM Chapter 4 Exhibit 8 for more details).

USE OF CDTFA–504 — XYZ LETTER PROCEDURE 0409.51

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

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

The "XYZ" Letter procedure utilizes the following forms:

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

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

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

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

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

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

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

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

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

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

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

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

WHEN GOOD FAITH OF SELLER IS QUESTIONED 0409.55

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

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

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

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

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

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

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

PURCHASE ORDERS AND RESALE CERTIFICATES 0409.60

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

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

MISUSE OF RESALE CERTIFICATE 0409.62

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

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

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

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

TAX ASSESSED ON PURCHASER 0409.63

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

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

TAX BILLED BY VENDOR BUT DELETED BY PURCHASER 0409.65

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

VERIFICATION OF PAYMENT OF USE TAX BY PURCHASER 0409.70

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

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

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

DROP SHIPMENTS 0409.75

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

Sales and Use Tax Transactions:

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

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

Use Tax Transactions:

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

MULTISTATE TAX COMMISSION MULTIJURISDICTION RESALE CERTIFICATE 0409.80

The Multistate Tax Commission (MTC) issued the multijurisdiction resale certificate (MTC certificate) in July 2000 to provide a standard document for businesses to utilize that will be uniformly accepted by sellers. Along with many other states, California adopted the MTC certificate. The certificate contains all of the required elements stated in Regulation 1668, *Resale Certificates,* and can be furnished as either a "blanket" or a "qualified" certificate. In reviewing the certificate, an auditor should determine if the MTC certificate is written as a blanket or a qualified resale certificate.

Under a blanket MTC certificate, all tangible personal property described on the certificate is deemed to be sold for resale unless the resale certificate is superseded by a purchase order. To be accepted as a blanket resale certificate, the purchaser must complete the form in its entirety and add a general description of tangible personal property or taxable services to be purchased from the seller. All sales of property stated to be for resale on the certificate can then be sold to the purchaser without tax. If the purchaser <u>subsequently</u> issues a purchase order indicating that the purchase is taxable, the resale certificate does not apply to that purchase. However, the burden is on the purchaser to establish that the purchase order was sent to and received by the seller in a timely manner or that the tax was paid to the seller.

When a purchaser issues a qualified MTC certificate, the burden is upon the seller to examine each purchase order issued by its customer to determine if the purchase is subject to tax or is for resale. To be accepted as a qualified resale certificate, the certificate must be completed in its entirety and the "general description" line should contain the statement "see purchase order" or be left blank. Each purchase order must specify whether the property covered by the order is for resale or taxable. A purchase order containing any of the terminology included in Item 2 of AM section 0409.50, indicating that tax or tax reimbursement should not be added to the sales invoice, will be regarded as designating that the property described is purchased for resale. If the purchase order does not specify the merchandise is for resale, the purchase is presumed to be the purchaser's own use and the sale is subject to tax. Item 2. of AM section 0409.50 also addresses purchase orders where the applicable amount of tax is shown as $0 or is left blank.

An example of the multijurisdiction MTC Uniform Sales & Use Tax Certificate can be found on the Multistate Taxation Commission website.

AUDIT OF SALES TO THE U. S. GOVERNMENT 0410.00

GENERAL 0410.05

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

(a) Sales tax does not apply to sales to:

- The United States or its unincorporated agencies and instrumentalities.
- Any incorporated agency or instrumentality of the United States wholly owned by either the United States, or by a corporation wholly owned by the United States.
- The American National Red Cross, its chapters and branches.
- Incorporated federal instrumentalities not wholly owned by the United States, unless federal law permits taxing the instrumentality. Examples of incorporated federal instrumentalities exempt from tax are federal reserve banks, federal credit unions, federal land banks, and federal home loan banks.

(b) Use tax does not apply to the storage, use, or other consumption of tangible personal property by agencies or instrumentalities of the United States unless federal law permits taxing the agency or instrumentality.

(c) Neither sales nor use tax applies to sales of machinery and equipment to United States construction contractors or subcontractors, provided title to the property passes to the United States before the contractor makes any use of it. Such sales are sales for resale, and the purchasing contractor may issue a resale certificate. A contractor who uses the machinery or equipment before title passes to the United States is the consumer of property, and either sales tax or use tax applies with respect to the sale to or the use by the contractor. The application of tax to consumable supplies and overhead materials on United States Government Supply Contracts (Regulation 1618) is covered in section 0411.00.

(d) Generally, either the sales tax or the use tax applies with respect to sales of tangible personal property (including materials, fixtures, supplies, and equipment used to perform the construction contract) to United States construction contractors for use in the performance of such contracts for the construction of improvements on or to real property in this state (Regulation 1521).

(e) Tax does not apply to the sale of items to a person insured pursuant to Part A of the Medicare Act as such sales are considered exempt sales to the United States (Regulation 1614).

AUDITING PROCEDURE 0410.10

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

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

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

Sales to contractors who are engaged in work on projects owned by the United States Government are not sales to the Government. If the contractor is actually selling tangible personal property to the U.S. Government, such sales are sales for resale and should be verified as such. Mention is made of this in this AM section only because many retailers classify such sales as sales to the United States Government and erroneously claim the deduction under that heading rather than sales for resale. If the auditor has reason to believe the material purchased was not actually sold by the contractor-customer to the U.S. Government, CDTFA–1164 (see AM section 0401.02), should be prepared setting forth all pertinent phases of the transaction.

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

The federal government issues credit cards to its employees for purchases of goods and services. In November 1998, federal agency purchase card programs began operating under GSA's SmartPay initiative. New purchase card contracts—known collectively as SmartPay2—took effect government-wide in November 2008. Prior to 2018 the cards just said "SmartPay". In November 2018, all federal agencies began operating under "SmartPay3" contracts.

The new contract, GSA SmartPay3, credit card brands are MasterCard, Visa, Wright Express (WEX) and Voyager, effective November 30, 2018, through November 29, 2031. Credit Cards under this program are issued by Citibank, WEX and U.S. Bank. Purchases made with most cards are directly billed to the U.S. government and will represent nontaxable sales to the U.S. government, (a Centrally Billed Account (CBA)). Those purchases directly billed to the employee are subject to sales tax, (an Individually Billed Account (IBA)). To determine which government credit cards are government-billed and which are employee-billed, retailers will have to consider the type of card, the type of transaction, and the card account numbers. Generally, through use of the Bankcard System and coding authorization, purchases are automatically denied if a particular type of card is used to make a type of purchase for which that card was not issued.

Travel purchases may be either government-billed or employee-billed depending upon the account number. To determine whether travel purchases are government-billed or employee-billed, retailers must look at the 6th digit of the account number of the card. If the 6th digit is 1, 2, 3, or 4, purchases are billed to the employee and are taxable. If the 6th digit is 0, 6, 7, 8, or 9, purchases are billed to the U.S. Government and are not taxable. (See tables below.) If the 6th digit is 5, the purchase may be either government billed or employee billed and requires further investigation by the auditor.

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

All U.S. government debit and credit cards:

- Are issued to federal employees,
- Bear 16-digit account numbers with unique prefixes,
- Contain government-designed artwork,
- Are imprinted with "United States of America" and for "Official Government Use Only," and
- Contain a "SmartPay" logo.

"**Purchase"** GSA SmartPay3 cards identification: (Used to pay for supplies or services procured at the direction of a Federal agency/organization)

Note: "Purchase" cards are CBA, therefore always exempt.

Bankcard Type	**Prefix on Card**
Visa Preflix	4614, 4716
Mastercard Prefix	5565,5568

"Fleet" GSA SmartPay3 cards identification: (Used for the purchases of fuel, maintenance and repair of government owned/operated vehicles, vessels and aircraft)

Note: "Fleet" cards are CBA, therefore always exempt.

Bankcard Type	**Prefix on Card**
Visa Prefix	4486,4614
Mastercard Prefix	5563,5565,5568
Wright Express	5565,6900,7071
Voyager	7088

"Travel" GSA SmartPay3 cards identification: (Used for transportation, lodging, meals and incidentals)

Note: "Travel" cards can be CBA or IBA, therefore can be either taxable or exempt. See the last table for guidance.

Identifying card purchases as taxable or exempt.

SmartPay3 Card Type	6th digit	Taxable or Exempt
Tax Advantage (CBA/IBA) - 6th digit of card number	5	Taxable or Exempt
Centrally Billed (CBA) - 6th digit of card number	0,6,7,8 or 9	Exempt
Individually Billed (IBA) - 6th digit of card number	1,2,3 or 4	Taxable

Note: Per GSA, Tax Advantage cards are programmed to distinguish taxable and exempt sales at the time of purchase, as identified by their Merchant Category Code. For example, lodging and rental cars charged on a Tax Advantage card will be billed to the CBA as exempt at the point of sale and all charges for meals and incidentals will be billed to the IBA as taxable at the point of sale.

UNITED STATES GOVERNMENT SUPPLY CONTRACTS 0411.00

GENERAL 0411.05

The contract between the United States Government and the government supply contractor determines when title passes for property used in the performance of the contract. If title passes prior to use, the supply contractor may purchase the property for resale to the United States Government and the subsequent sale to the United States Government is exempt under section 6381 of the Revenue and Taxation Code. Exhibit 9E provides a decision table that may be used to assist the auditor in deciding if title to the property passes prior to use.

The United States Government established the Federal Acquisition Regulation (FAR) to set uniform policies and procedures for the acquisition of goods and services. Individual agencies may issue supplements to FAR that may supersede the current FAR if there is a conflict. Because of potential revisions to FAR and the agency supplements, contracts should be reviewed to determine what clauses are included. (See sections 0411.15 and 0411.25 for classified contracts exception.) Several of the standard definitions and clauses are included as Exhibit 9A. The FAR is accessible at https://www.acquisition.gov/. The auditor should check the website for current versions of applicable clauses.

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

TITLE CLAUSES 0411.10

Generally, title will transfer to the government under one of the following three FAR title clauses:

FAR 52.245-1, Government Property (Exhibit 9D)

The clause has different title passage provisions for fixed price contracts, cost reimbursement or time and material contracts, or cost reimbursement line items under fixed price contracts. In cost reimbursement or time and material contracts, or cost reimbursement line items in fixed price contracts, title passes prior to use for reimbursable items. In fixed price contracts, this clause will not pass title to items to the government unless the item is a deliverable or a cost-reimbursable contract line item. However, title to property may still pass to the government prior to use under one of the payments clauses. Also note that there is an alternate title clause for basic or applied research at nonprofit institutions of higher education or at nonprofit organizations whose primary purpose is the conduct of scientific research.

FAR 52.232-16, Progress Payments (Exhibit 9B)

Title passes at the date of the contract for property purchased prior to that date. Otherwise, title passes at the time the property is allocable or should have been allocable to the contract.

FAR 52.232-32, Performance-Based Payments (Exhibit 9C)

Title passes at the time of the first performance-based payment for property purchased prior to that date. Otherwise, title passes at the time property is allocable or should have been allocable to the contract. If title passes under this clause, there is the potential for use of the property prior to title passing to the United States Government for items purchased prior to the first payment. If there is a use prior to the first performance-based payment, the use by the contractor will generally be taxable.

In addition to the clauses described above, a contract could contain a title clause specific to that contract.

TYPES OF CONTRACTS 0411.15

The contract types are grouped into two broad categories: fixed-price contracts and cost-type contracts. The specific contract types range from firm-fixed-price, in which the contractor has full responsibility for the performance costs and resulting profit (or loss), to cost-plus-fixed-fee, in which the contractor has minimal responsibility for the performance costs and the negotiated fee (profit) is fixed. In between there are the various incentive contracts, such as flexibly-priced contracts, in which the contractor's responsibility for the performance costs and the profit or fee incentives offered are tailored to the uncertainties involved in contract performance.

Cost Reimbursement Contracts

FAR 45.107 states cost-type contracts, including time and material contracts, shall contain FAR 52.245-1, the government property clause. The only exception is for purchase orders for property repair that do not meet the simplified acquisition threshold, generally set at $150,000 based on FAR 2.101. Therefore, the auditor may presume that a cost-type contract, including a fixed price contract with cost-reimbursable contract line items, contains the government property clause. The auditor should consider materiality when deciding to review the contracts potentially falling under the property repair exemption.

Fixed Price Contracts

In fixed price contracts, the government property clause, FAR 52.245-1, passes title to contract deliverables and cost-reimbursable contract line items. In order to pass title to overhead supplies or consumables not directly provided for in the contract, the contract must contain either the progress payments clause or the performance-based payments clause described in section 0411.10. Fixed price contracts greater than $2.5 million and contracts with qualifying small business concerns are eligible for contract financing and may contain either the progress payments clause or the performance-based payments clause. According to the Defense Contract Management Agency (DCMA), if progress payments are provided, the contract must contain the progress payment clause and if performance-based payments are provided, the contract must contain the performance-based payment clause. If the contract contains either clause, title would pass based on the provisions of the payment clause.

Flexibly Priced Contracts

A flexibly priced contract can be either a Fixed, Cost Reimbursement, or Time and Material contract. Passage of title is based on the type of contract and the FAR clauses noted in section 0411.10 that are included in the contract.

Direct Consumables

"Direct consumable supplies," as defined by Regulation 1618, are those supplies which are consumed in the performance of a contract and are specifically identified to the contract and charged as a direct item of cost to the contract. In cost-type contracts, title transfers prior to use for reimbursable costs. However, in fixed price contracts, title passage under the government property clause is dependent on whether the cost is reimbursable and whether the contract has a provision directing the contractor to purchase the property as a direct item of cost.

Special tooling and special test equipment are generally treated in the same manner as other direct consumable supplies. The Progress Payments clause and the Performance-Based Payments clause pass title to that special tooling or special test equipment to which the Government will acquire title. According to DCMA, the Government will only finance the special tooling or special test equipment if it has acquired title to the special tooling or special test equipment. Therefore, once the Government finances the special tooling or special test equipment, the auditor may assume that the Government has acquired title to the property. If the contract contains either the Progress Payment clause or the Performance-Based Payment clause, title will pass according to the provisions of that clause.

Indirect Consumables

"Indirect consumable supplies" (overhead materials) are supplies consumed in the performance of a contract, the cost of which is charged to an overhead expense account and then allocated to various contracts based on generally accepted accounting principles. Title to indirect consumables will pass prior to use in cost reimbursement contracts, time and material contracts and cost-reimbursable line items in fixed price contracts. Otherwise, in order for title to pass prior to use, the contract must contain a financing payments clause and title will pass as provided for under that clause. For title to pass at the time provided under a contract's payment clause, the contractor must allocate the overhead materials among the various commercial and qualifying and non-qualifying government contracts by means of a reasonable system of allocation which conforms to governing federal regulations and generally accepted accounting principles. One acceptable method is an allocation based on direct labor hours.

"Overhead materials" includes amounts recorded in cost accumulation pools that are allocated to qualifying and non-qualifying contracts including United States Government and commercial contract(s). Contractors may have Independent Research and Development (IRAD) and Bid and Proposal (B&P) accounts that accumulate costs for these two tasks. These costs are not taxable if (1) the purchased item is non-taxable (i.e. labor only, electronically delivered software, etc); or (2) a qualifying United States Government contract was in existence at the time of use and such costs were allocated to such contracts. For example, bid and proposal expenses will be subject to tax if they include purchases of tangible personal property and are incurred at a time when no qualifying government contract was in existence. Some contractors may accumulate the IRAD and B&P costs in projects as if they were contracts. However, they are not contracts but costs.

Leases

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

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

Should a Department of Defense contractor nevertheless claim agency relationship with respect to a lease, the contractor is required to provide documentation to support such claim. The documentation should be submitted to the Chief, Tax Policy Division, with a copy to the Deputy Director, Field Operations Department. The Chief, Tax Policy Division will communicate with the Secretary of Defense to ascertain the Department's position with respect to the specific contract.

AUDITING PROCEDURES 0411.25

Classified or Proprietary Contracts

Based on federal regulations, the auditor may not view classified or proprietary contracts because they do not have sufficient security clearance. Generally, these types of contracts are cost-type contracts, including time and material contracts, and therefore are required to contain the government property clause. If the auditor can verify through other documentation that the contract is a cost reimbursement contract, a time and material contract or a fixed price contract with cost-reimbursable contract line items, the auditor may accept that the contract contains the government property clause without reviewing the actual contract.

The supply contractor is required to submit their costs to the government on a form, often called the Incurred Cost Schedule, listing the contract number, type of contract (cost, fixed, etc), and a summary of the costs. The auditor may be able to identify the type of contract by this form which is subject to disclosure and available for the auditor's review. This form may have different names, but relates to the Indirect Cost document that is provided by the Contractor to Defense Contract Audit Agency (DCAA) / Defense Contract Management Agency (DCMA) on an annual basis.

If the contract is a fixed price contract, the auditor cannot assume that title passes prior to use. The auditor should verify that the contract contains a clause that passes title prior to use, as described in section 0411.10, before accepting that the sales qualify as exempt sales to the United States Government. However, the auditor may explore alternative audit methods that determine, with the least possible expenditure of time, the correct amount of tax due.

Regardless of the type of contract, staff must develop a comprehensive understanding of the internal accounting practices of the United States Government contractor under audit, including the accounting system, cost flows, and internal controls. Review of the Government Contractor's Disclosure Statement, which is reviewed by DCAA on an annual basis to verify adherence to accounting practices identified in the Disclosure Statement may help the auditor gain an understanding of the contractor's records. The auditor must be able to verify that the supplies and goods purchased for resale to the United States Government are in fact resold or that tax has been paid on the purchase price. On a test basis, the auditor should trace the posting of the purchases to an overhead account, verify the allocation method, and confirm the submission of the cost to the United States Government. For example, the auditor could identify the accounting pool associated with the overhead account to which the purchase was charged and review the Incurred Cost Schedule (submitted to DCAA on an annual basis) to verify the pool's allocation to the Government contracts.

AUDIT OF CASH DISCOUNTS 0412.00

GENERAL 0412.05

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

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

ACTUAL CASH DISCOUNTS TAKEN ON TAXABLE SALES 0412.10

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

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

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

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

COMPOSITE PERCENTAGE OF DEDUCTIONS TAKEN 0412.15

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

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

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

PERCENTAGE OF TOTAL DISCOUNTS TAKEN 0412.20

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

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

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

$$\text{Allowable Discounts} = \frac{\text{Discounts Taken on Taxable Sales – Tax}}{\text{Total Discounts Taken}} \text{ X Discounts Taken}$$

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

TRADING STAMPS 0412.25

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

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

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

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

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

SALES PROMOTION PLANS 0412.30

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

SALES TAX INCLUDED IN CASH DISCOUNTS 0412.35

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

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

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

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

AUDIT OF RETURNED MERCHANDISE 0413.00

GENERAL 0413.05

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

- The original sale is included in reported taxable sales.
- The full sales price, including sales tax, is refunded either in cash or credit. For purposes of the returned merchandise deduction, "full sales price" is construed to include only amounts required to be included in the measure of tax under RTC sections 6011 and 6012, plus any sales tax added. Charges not required to be included in the measure of tax, such as nontaxable shipping charges, need not be refunded in order to claim the returned merchandise deduction (even if sales tax was erroneously collected on such charges).
- The customer is not required to purchase other property at a price greater than the amount charged for the property returned in order to obtain the refund or credit.

Refund or credit of the entire amount is deemed to be given when the purchase price and sales tax, less rehandling and restocking costs, if any, are refunded or credited to the customer. The refund or credit should be computed in the following manner:

Example 1

Price of merchandise returned	$100.00
Sales tax at 7.5%	$7.50
Total	$107.50
Restocking and rehandling charge	$10.00
Amount refunded or credited	$97.50

If the retailer sets up a credit in its books rather than refunding cash, the retailer must provide proof that the customer was notified of the available credit. Generally, a deduction for returned merchandise should not be allowed if the retailer did not give written notice to the customer that the credit is available.

METHODS OF CLAIMING THE DEDUCTION 0413.10

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

- As debits to an account in the general ledger, and claimed as a deduction on the sales tax return. The deduction, when handled in this manner, should be audited in the same way as any other deduction.
- As debit entries in the sales journal (therefore, a reduction in sales) with no deduction being shown on the sales tax returns. When this procedure is followed the verification of the deduction should be made in conjunction with the audit of total sales (AM section 0413.20).

AUDITING PROCEDURE — DEDUCTION CLAIMED 0413.15

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

AUDITING PROCEDURE — DEDUCTION NETTED FROM SALES 0413.20

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

SHIPPING AND HANDLING CHARGES 0413.23

Under RTC sections 6011 and 6012, as explained in Regulation 1628, *Transportation Charges,* separately stated charges for transportation from the retailer's place of business or other point from which shipment is made directly to the purchaser are not subject to tax. The amount of transportation charges excluded from the measure of tax shall not exceed the actual cost of the transportation. If a separately stated charge is made designating "postage and handling" or "shipping and handling," only that portion of the charge which represents actual postage or actual shipping may be excluded from the measure of tax. The amount excluded from the measure of tax need not be refunded in order for a retailer to claim a returned merchandise deduction. If tax is erroneously collected on nontaxable shipping charges, this amount also does not need to be refunded because it constitutes excess tax reimbursement which has already been properly remitted to the State (AM section 0417.00).

Handling charges are included in the definitions of "sales price" and "gross receipts" and are included in the measure of tax. Therefore, handling charges, including the portion of the sales tax related to the handling charges, must be refunded to the customer in order to claim the returned merchandise deduction.

In cases where a deduction is claimed for the returned merchandise but the taxpayer does not refund the amount attributed to handling, this will be deemed to be a restocking charge. The retailer will be permitted a returned merchandise deduction as long as the handling amount does not exceed the actual cost of restocking. The auditor should accept the deduction without further examination in cases where the handling charge is less than 10 percent of the sales price attributed to the actual merchandise in the original transaction.

If the handling charge is in excess of 10 percent of the sales price of the merchandise, the auditor should examine a sample of transactions to ensure the handling charge does not exceed the actual cost of restocking the merchandise. When "postage and handling" or "shipping and handling" charges are billed as lump sum, the handling charge would be considered the lump sum charge minus the actual cost of postage or shipping.

Example 2

A retailer makes a sale and charges the customer:

Sale	$100.00
Shipping and Handling	$15.00
Subtotal	$115.00
Sales Tax (7.5% X $115)	$8.63
Total	$123.63

The retailer remits the full amount of the tax to the State. When the merchandise is returned, the retailer refunds:

Returned Merchandise	$100.00
Sales Tax (7.5% X $100)	$7.50
Total	$107.50

The actual cost of shipping is $8 and the handling charge is therefore $7 ($15 - $8 = $7). The auditor should accept the returned merchandise deduction because the $7 handling charge is less than 10 percent of the selling price of the merchandise ($7/$100); therefore, the retailer is allowed to retain that amount as a restocking fee.

When determining whether the returned merchandise deduction should be examined further, staff must first rely upon the use of aggregate data as illustrated in Example 3 as the intent of the 10 percent threshold is to avoid detailed testing. This is especially true when it is highly improbable that the original handling charge is in excess of the actual cost of restocking merchandise.

Example 3

Assume the same facts and circumstances noted in Example 2 above. Additionally, the taxpayer's records for the prior year state:

Total Sales (net of shipping and handling)	$15,000,000
Shipping and Handling Revenue	$1,000,000
Shipping Merchandise Expenses	$700,000

Under this scenario, staff would consider that $300,000 in revenue is derived from handling charges ($1,000,000 - $700,000). For the specific period in question, the handling charge is 2 percent of total sales ($300,000/$15,000,000). Since the handling charge is less than 10 percent of the merchandise sales, the claimed returned merchandise deduction should be accepted without further testing.

In the event that adequate documentation is not available to use aggregate data, staff should perform a cursory review of transactions to determine if the retailer qualifies under the 10 percent threshold explained above.

It is important to note that in cases where the handling portion exceeds 10 percent of the sales price, the returned merchandise deduction is not necessarily disallowed. The deduction must be further analyzed to verify whether the un-refunded handling portion of the original sale exceeds the actual cost of restocking the merchandise. Only in such cases should staff deny the claimed returned merchandise deduction or claim for refund.

REHANDLING AND RESTOCKING CHARGES 0413.25

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

1. The actual cost of rehandling and restocking the returned merchandise. The cost may include, but is not limited to the retailer's direct costs of the following:
   - Inspection of the merchandise after the request has been made for its return
   - Issuance of authorization for return of the merchandise after the request has been made for its return
   - Freight or delivery charge for shipment of the merchandise from the customer to the retailer
   - Returning the merchandise to stock, and
   - Direct "paper work" involved in the return of merchandise such as preparation of credit memos, accounts receivable corrections, inventory record adjustments, etc., to the extent that it is possible to determine these costs.
2. A percentage of the sales price based on the average cost of rehandling and restocking returned merchandise.
   The percentage must be based on the average of the actual costs of rehandling and restocking the returned merchandise for the entire previously completed accounting cycle (normally one year). The percentage is computed by dividing the total allowable rehandling and restocking costs incurred in the previous accounting cycle by the total sales price (excluding sales tax) of the merchandise returned during that period. Retailers choosing the percentage of sales method may not:
   - Use industry-wide averages
   - Use actual cost during any accounting cycle in which an election was made to use the percentage method.

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

RETURN OF TAX REIMBURSEMENT 0413.26

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

EXAMINATION OF ACCOUNTS RECEIVABLE 0413.30

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

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

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

DEFECTIVE MERCHANDISE 0413.35

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

PRICE ADJUSTMENTS 0413.40

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

AUDITS OF SALES IN INTERSTATE OR FOREIGN COMMERCE 0414.00

GENERAL 0414.05

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

AUDITING PROCEDURE — SHIPMENTS OUT-OF-STATE 0414.10

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

(a) Delivery by facilities operated by the retailer

- Correspondence
- Delivery receipts
- Expense vouchers supporting delivery expense

(b) Shipment by carrier

- Freight
  - Bills of lading
  - Freight invoices
- Express
  - Express receipts
  - Express company invoices
- Parcel post
  - Parcel post receipts
  - Record of parcel post shipments
  - In many instances the sales invoice will show parcel post charges and shipping instructions

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

- Bills of lading
  - The bill of lading shall include the identification of the invoice, contract number or other identification of the transaction involved and the identification of the export packer to which delivery is was made.
- Copies of import documents of foreign country
- Notation on invoice
- Invoices for services of customs broker or forwarding agent
- Delivery receipts

(d) Delivery to a steamship or other conveyance furnished by a foreign purchaser for shipment to a foreign destination.

- Bills of lading
- Import documents of a foreign country or other documentary evidence of export must be obtained and retained by retailers to support deductions taken.

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

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

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

CERTIFICATE OF VERIFICATION — OUT-OF-STATE DELIVERY 0414.12

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

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

Use of Form CDTFA–52 by Seller

In situations where it appears the taxpayer has met its responsibility in accounting for interstate commerce transactions, but lacks adequate documentation to support certain questioned items, the use of Form CDTFA–52 (Exhibit 12) and cover letter CDTFA–52–L (Exhibit 12A) should be discussed as an option. It should be explained to the taxpayer that this certificate may be used to request the purchaser's statement to help substantiate the claimed interstate commerce deduction. It should be emphasized that the return of the certificate may or may not be accepted as support for the claimed exemption.

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

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

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

Use of Form CDTFA–52 by Audit Staff

When the auditor has good reason to believe that merchandise was not shipped as specified by the shipping documents, or that empty boxes may have been shipped to purchasers as a means to support the interstate commerce exemption, it may be appropriate to use CDTFA–52 as a verification method for receipt of out-of-state shipments. In addition to the certificate, CDTFA–52–L1 (Exhibit 12B) provides a suggested cover letter for use by the districts in explaining the purpose of the certificate and requesting the purchaser's statement regarding receipt of the item and place of delivery. The decision to use this verification method should be based on the materiality of the questioned transaction(s) and on the surrounding circumstances. The auditor should prepare the certificate to be completed in triplicate. Postage-paid return envelopes may be included in the mailing to increase the likelihood of response for this case in which the CDTFA is seeking verification of shipment without seller involvement.

Returned Form CDTFA–52s

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

AUDIT PROCEDURE — SHIPMENTS INTO THE STATE 0414.15

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

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

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

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

AUDIT OF DEDUCTION FOR LABOR 0415.00

GENERAL 0415.05

Labor charges to customers may be classified in two categories:

(a) Exempt

- Installation
- Repair or reconditioning

(b) Taxable

- Fabrication
- Assembly

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

AUDITING PROCEDURE 0415.10

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

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

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

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

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

(a) Some repair jobs actually involve both repair and fabrication labor. For example a repairman may, of necessity, fabricate certain parts used in the repair.

(b) Some remodeling jobs may be either repair or fabrication labor depending upon the end product. For example, labor charges for rebinding a rug are classified as repair. However, labor charges for cutting a rug into two or more pieces and rebinding the pieces so that the customer receives two or more rugs is classified as fabrication labor.

(c) Audit of labor deductions claimed by construction contractors frequently involves complex problems. Many of these require differentiation between fabrication and installation labor. Others necessitate determining whether the contractor is the consumer or the retailer of the property furnished.

- A contractor may fabricate and install a fixture. The fabrication labor must be segregated from the installation labor to properly determine the tax liability.
- A construction contractor, when billing a time-and-material contract, may add tax reimbursement on a marked up price of materials. The amount billed and not the cost should be considered the selling price of the materials.

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

INSTALLATION OF ACCESSORIES - DETERMINING NEW OR USED VEHICLE, VESSEL, OR AIRCRAFT 0415.15

Labor charges to install accessories onto a vehicle, vessel, or aircraft may be subject to tax depending on whether the vehicle, vessel, or aircraft is new or used. A contractor's charge for labor to install accessories onto a used vehicle, vessel, or aircraft qualifies as nontaxable installation labor, while a labor charge to install accessories onto a new vehicle, vessel, or aircraft is subject to tax as fabrication labor. As it can be difficult for staff to determine whether the vehicle, vessel, or aircraft is new or used without obtaining registration information, this section provides guidance including time and distance tests to determine if the item is new.

For purposes of determining the taxability of labor charges, a vehicle, vessel, or aircraft is generally considered "new" if it meets both of the following:

- The vehicle, vessel, or aircraft qualifies as a new vehicle, vessel, or aircraft when the purchaser registers it with the Department of Motor Vehicles, the United States Coast Guard for certain vessels, or the Federal Aviation Administration for aircrafts.
- The installer enters into a contract to install accessories onto the vehicle, vessel, or aircraft within 60 days of the registration date.

However, in some situations, the registration date cannot be established. For example, the registration records for vehicles purchased by a police department may be confidential. In other situations, the vehicles, vessels, or aircraft were purchased new, then stored for more than 60 days, but not used for the purpose for which they were bought. Therefore, an alternative test is required. When the vehicle, vessel, or aircraft has been purchased with the intent that it will be modified to meet the purchaser's specific needs, the following alternative tests should be used in addition to the 60-day test:

Vehicle – *Odometer Reading Test*

- If the odometer reading on the vehicle is less than 500 miles, it is regarded as new.

Vessel – *Distance Traveled Test*

- If the vessel has traveled less than 20 nautical miles, it is regarded as new. For certain vessels without a GPS system with sufficient memory to show all trips, maintaining an accurate log will be necessary to document the distance traveled.

Aircraft – *Flight Hour Test*

- If the aircraft has traveled less than 20 flight hours, it is regarded as new.

If the vehicle, vessel, or aircraft's use is less than the above tests, the presumption is that the purchaser has not used the vehicle, vessel, or aircraft for the purchaser's intended purpose; therefore it is still regarded as new. This applies even if the vehicle, vessel, or aircraft has been registered for more than 60 days. For example, a vehicle was purchased new for the purpose of being used as a police car and was stored for 70 days. The vehicle was subsequently driven 400 miles prior to installation of the needed modifications. Under these facts, the vehicle would be considered new.

Nevertheless, staff should consider any supporting documentation the taxpayer may provide to show that the used vehicle, vessel or aircraft was in a used condition. Such documentation may include, but is not limited to, an affidavit from the purchaser affirming that he or she functionally used the vehicle, vessel, or aircraft prior to the installation at issue, and describing in detail how the vehicle, vessel, or aircraft was used. If possible, the taxpayer should include documentation from the time of use to support the affidavit.

AUDIT OF SALES TAX INCLUDED IN SALES 0416.00

GENERAL 0416.05

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

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

AUDITING PROCEDURE 0416.10

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

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

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

(a) That total amounts of sales tickets are entered in the sales journal.

(b) If sales tickets are not prepared, that sales tax is rung up on the cash register if it is added to selling prices.

(c) That where sales tax is not added to sales prices, effect was given to the tax by the retailer in determining the total sales prices.

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

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

Factors for other current tax rates are:

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

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

TREATMENT OF EXCESS TAX REIMBURSEMENT 0417.00

GENERAL 0417.05

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

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

REFUNDS OF EXCESS TAX REIMBURSEMENT 0417.07

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

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

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

The retailer should maintain records as provided in Regulation 1700(b)(3) as evidence that the excess amounts have been or will be returned to the customer. As explained below, staff should encourage retailers to use Form CDTFA-52-L2, *Notice of Pending Refund of Excess Sales Tax Reimbursement,* (Exhibit 12C) to notify and obtain acknowledgement from customers of the pending refund.

All audits involving refunds of excess tax reimbursement must have copies of signed acknowledgement forms included in the audit working papers. Form CDTFA–52–L2 is available to assist retailers in obtaining sufficient evidence from customers that excess tax reimbursement has been or will be returned to the customer and to assist retailers in notifying and obtaining acknowledgement from customers of the pending refund. Form CDTFA-52-L2 also allows retailers to assign a limited *Power of Attorney* to their customers for purposes of obtaining the status of a claim for refund of excess tax reimbursement. The limited power of attorney is optional and only applies to refunds of excess tax reimbursement of $300,000 or more.

Auditors should encourage retailers to complete the CDTFA–52–L2 letter for each customer affected and retain the customers' signed responses. When a claim for refund of excess tax reimbursement is $300,000 or more, auditors should also encourage retailers to grant the limited power of attorney to their customer. Without the limited power of attorney, the CDTFA cannot divulge information on the status of a refund to the retailer's customer.

Form CDTFA-52-L2 informs the customer of the amount of indebtedness in writing and provides a check box for the customer to indicate their preference of a refund or credit to their account for the amount of excess sales tax paid. The retailer must obtain and maintain the signed acknowledgement in their records as proof of the refund or credit being given.

Retailers are not required to use this form, however any other type of documentation used by the retailer must satisfy all of the requirements under Regulation 1700 (b)(3) that show excess tax amounts have been or will be returned to the customer. Auditors are required to include a signed copy of Form CDTFA-52-L2 or other documentation in the *Supporting Audit Documents* subfolder of the digital audit case folder for all audits involving refunds of excess tax reimbursement, regardless of the amount of refund,

When CDTFA staff receives a request from a customer regarding the status of a claim for refund of excess tax reimbursement, staff may provide the status of the claim to the customer after obtaining verification that the customer has been granted limited power of attorney by the retailer to disclose this information to the customer. Staff may obtain verification of the customer's limited power of attorney either from the customer or through the digital audit archive file of the retailer/taxpayer who made the claim.

Form CDTFA–52–L2 is available on myCDTFA.

AUDITING PROCEDURE 0417.10

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

OFFSETS 0417.15

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

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

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

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

SPECIFIC APPLICATIONS 0417.20

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

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

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

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

AUDIT OF MEDICINES 0418.00

GENERAL 0418.05

Revenue and Taxation Code (RTC) section 6369, *Prescription Medicines*, exempts from tax the sale, use or other consumption of medical products that qualify as "medicines," provided that certain additional conditions discussed below are met. Regulation 1591, *Medicines and Medical Devices,* interprets and implements the statute. To determine whether the sale or use of a product qualifies for the exemption, it must first be determined whether the product is a "medicine" as defined by the statute and regulation. See AM section 0418.10 for an explanation of how medicines are defined.

Second, the sale or use of the "medicine" must occur under one of the following conditions, listed in Regulation 1591, subdivision (d):

1. The medicine is prescribed for the treatment of a human being by a person authorized to prescribe the medicine, and dispensed on prescription filled by a pharmacist;
2. It is furnished by a licensed physician, dentist or podiatrist to his or her own patient for treatment of the patient;
3. It is furnished by a health facility for treatment of any person pursuant to the order of a licensed physician, dentist or podiatrist;
4. It is sold to a licensed physician, dentist, podiatrist or health facility for the treatment of a human being;
5. It is sold to this state or any political subdivision or municipal corporation thereof, for use in the treatment of a human being; or furnished for the treatment of a human being by a medical facility or clinic maintained by this state or any political subdivision or municipal corporation thereof; or
6. It is furnished by a pharmaceutical manufacturer without charge to a licensed physician, surgeon, dentist, podiatrist, or health facility for the treatment of a human being, or to an institution of higher education for instruction or research.

Certain medical products that do not qualify for exemption under RTC 6369 may be exempt under other statutes. When appropriate, the auditor should also refer to the following regulations:

- 1591.1 *Specific Medical Devices, Appliances, and Related Supplies*
- 1591.2 *Wheelchairs, Crutches, Canes, and Walkers*
- 1591.3 *Vehicles for Physically Handicapped Persons*
- 1591.4 *Medical Oxygen Delivery Systems*

DEFINITIONS 0418.10

Regulation 1591 subdivision (a)(9)(A) defines "medicines" as follows: "except where taxable for all uses as provided in subdivision (c), any product fully implanted or injected in the human body, or any drug or any biologic, when such are approved by the U.S. Food and Drug Administration to diagnose, cure, mitigate, treat or prevent any disease, illness or medical condition regardless of ultimate use." Subdivision (a)(9)(B) further states that "medicines" means "any substance or preparation intended for use by external or internal application to the human body in the diagnosis, cure, mitigation, treatment, or prevention of disease and which is commonly recognized as a substance or preparation intended for that use."

Subdivision (c) lists items that are generally excluded from the definition of "medicines." Specifically, subdivision (c) generally excludes from the definition of "medicines" certain products including: 1) "orthodontic, prosthetic (except as described in subdivision (b)(5)), auditory, ophthalmic or ocular devices or appliances;" 2) "articles which are in the nature of splints, bandages, pads, compresses, supports, dressings, instruments, apparatus, contrivances, appliances, devices, or other mechanical, electronic, optical or physical equipment or articles or the component parts and accessories thereof;" 3) "any alcoholic beverage the manufacture, sale, purchase, possession or transportation of which is licensed and regulated by the Alcoholic Beverage Control Act."

Subdivision (b)(1) provides further clarification as to the definition of substances and preparations as used in subdivision (a)(9)(B). Subdivision (b)(2)-(6) lists items that are also included in the definition of "medicines" even though they are of the type generally excluded in subdivision (c). This means that certain products such as breast tissue markers or neck collars, which would otherwise be generally excluded from the definition of medicines pursuant to subdivision (c), do qualify as medicines under the additional definitions provided in subdivision (b)(2)-(6).

AUDITING PROCEDURES 0418.15

In General

The application of tax to sales of medical products can be complicated. Due to rapid technological advancements in the field of medicine, it is important that the auditor ensure proper application of the laws, rules, and regulations pertaining to medical products. When determining whether tax applies to the sale, use, or other consumption of a particular product, an auditor should first determine whether the product falls within the definition of a medicine, and next, whether the medicine is sold or used under one of the conditions described in Regulation 1591 subdivision(d).

In applying the regulation to audit situations, the auditor must recognize that the provisions in Regulation 1591 subdivisions (a), (b), and (c) are interrelated, and all three may have to be considered when determining if a particular medical product meets the definition of "medicines." The definition of medicines may cause confusion during an audit, particularly because the layout of the regulation requires that it be read and applied in a somewhat non-sequential fashion.

1. Subdivision (a)(9)(A) is most important when it is determined that a product is not being used in a way that meets the definition of "medicines" under subdivisions (a)(9)(B) and (b), but could be used in a different manner (see below).

   So an auditor should begin their analysis with subdivision (a)(9)(B). If the item is a preparation or substance intended for external or internal application to the human body in the diagnosis, cure, mitigation, treatment or prevention of disease, it will generally qualify as a medicine under subdivision (a)(9)(B) and subdivision (b)(1), which provides additional guidance for these types of items. (Note that alcoholic beverages are excluded from the definition of "medicines" (Subdivision (c)(3).))

2. If an item is not a preparation or substance, the auditor should then determine whether the product meets any of the additional definitions of “medicines” set forth in subdivision (b)(2)-(6). Again, if the product qualifies as a medicine under one of these provisions, that is the end of the analysis.

   If the item is not described in subdivisions (b)(2)-(6) it will generally be excluded under subdivision (c). However, it is necessary at this point for the auditor to consult subdivision (a)(9)(A) to complete the analysis.

Subdivision (a)(9)(A) includes the phrase, “… regardless of ultimate use.” This phrase means that if an item has multiple possible uses and meets the definition of “medicines” under subdivision (a)(9)(A) when put to a particular purpose, it will qualify as a medicine regardless of whether or not it is being used for that purpose. Thus, for example, an item like Botox, which has both a qualifying medical use under subdivision (a)(9)(A), and a cosmetic use, will qualify as a medicine even when prescribed and sold for cosmetic use.

Accordingly, the auditor should determine whether the item has any use that qualifies it as a medicine under subdivision (a)(9)(A), regardless of whether or not it is being used for that purpose in the particular instance. Note that an item that is “taxable for all uses as provided in subdivision (c)” does not meet the definition of medicine under (a)(9)(A). As a result, in order for an item to be a medicine under (a)(9)(A), it must not be of the type generally excluded under (c) or it must be covered by one of the additional definitions of medicines in subdivision (b).

Specialized Rules for Particular Items

Staff should also review Regulation 1591.1 *Specific Medical Devices, Appliances, and Related Supplies*, Regulation 1591.2 *Wheelchairs, Crutches, Canes, and Walkers*, Regulation 1591.3 *Vehicles for Physically Handicapped Persons*, and Regulation 1591.4 *Medical Oxygen Delivery Systems* to determine whether the item at issue is specifically included in the definition of medicine by one of these sections.

PRESCRIPTION PHARMACIES 0418.25

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

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

AUDIT OF OTHER DEDUCTIONS 0419.00

AUDIT OF BAD DEBT DEDUCTIONS — GENERAL 0419.03

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

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

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

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

An example of a computation of the allowable loss follows:

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

$$\frac{\$200}{\$224} \text{ x } \$149 = \$133$$

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

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

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

AUDITING PROCEDURE 0419.10

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

- *Was Sale Prior to a Change in the Tax Rate?*
  An adjustment must be made to compensate for the tax rate differential between sales made at one rate and claimed as bad debts after the rate has changed or a district tax has been added or discontinued. The audit report should be completed in such a manner than tax credit will be given for state, local, county and district tax.
- *Effect of Charging an Account Other Than Bad Debt Expense for the Repossession Loss*
  Many accounting systems require charging repossession losses directly against the cost of goods sold or other cost account rather than Bad Debt Expense. This method has the same general effect on the financial condition and therefore is an acceptable write-off method.
- *Effect of Reporting on a Cash Basis*
  If retailers have been reporting their sales tax liability on a cash basis, ordinarily no bad debt deduction will be allowed. This is because sales tax has not previously been paid on the accounts deemed to be worthless. If accounts receivable have been picked up in a previous audit, a bad debt deduction may be allowed for any such receivables which subsequently go bad even though the taxpayer continued to report on a cash basis.
- As provided in Regulation 1642, Bad Debts, a bad debt deduction will not be disallowed solely for the reason that a retailer is on a cash reporting basis for income tax purposes.
- *Consolidation of Debts*
  The auditor should determine that the remaining contract balance (net payoff) is a measure of the taxable sale only. Some retailers consolidate other debts of the customer into the contract which do not pertain to the allowable loss.
- *Worthless Accounts Subsequently Collected*
  General accounting records should be reviewed to determine that collections of previously written off accounts have been properly reported for sales tax purposes. These should be reported on the same pro-rate basis used for claiming the bad debt deductions, i.e., ratably allocated to the taxable and nontaxable elements of the original sale. If, however, delinquency charges have accrued, collections may be applied to such charges first and remainder then pro-rated to determine the taxable portion to be reported.
- *Collection Expense*
  Collection agencies charge a fee for their services, normally 50% of the amount collected by them. Any amount paid directly to or retained by a collection agency in attempting to enforce collection of amounts owing is not allowable as part of the bad debt loss.
- Review should be made of receipts from the collection agency to assure that amounts shown as collected are gross, including the collection charge.
- *Insurance Indemnification*
  Review of accounting records should include a search for insurance recoveries on accounts receivables, property damage, and similar type insurance policies applicable to sustained bad debt losses. Any such indemnification should be used to reduce the allowable bad debt loss.
  The verification of repossession losses should include, as standard procedure, sufficient testing to insure that all repossessed merchandise is brought back into inventory or has been resold. A comparison of the value used for computing the bad debt loss with the subsequent selling price should show a reasonable relationship.

SPECIAL SITUATIONS 0419.15

Bad Debts Incurred by Lessors

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

Bad Debt Deductions to Persons Other Than the Retailer

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

Bad Debts of Construction Contractors

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

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

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

EXAMPLE:

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

Annual percentage of taxable sales per return to net register =

$$\frac{\textbf{(B) Merchandise Sales per Return}}{\textbf{(A) Net Register Sales}}$$

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

	(I) CARRYING CHARGES AT WRITE OFF	(II) TOTAL WRITE OFF	(I+II) CARRYING CHARGES AS % OF TOTAL WRITE OFFS
30 Day	$0.00	$0.00	0.0%
Revolving	0.00	0.00	0.0
Service	0.00	0.00	0.0
Lease	0.00	0.00	0.0
Total	$0.00	$0.00	0.0

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

	(I) TOTAL CHARGE OFFS-LAST TWO YEARS	(II) TOTAL RECOVERIES-LAST TWO YEARS	(III) NET LOSS (I-II)
30 Day	$0.00	$0.00	0.0%
Revolving	0.00	0.00	0.0
Service	0.00	0.00	0.0
Lease	0.00	0.00	0.0
Total	$0.00	$0.00	0.0

- **Average Net Loss Percent=**
- **<u>Total Column III</u>**
- **Total Column I**

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

a. Apply the percentage obtained in (3) to the total accounts being written off. Thus, anticipated future recoveries are taken into consideration at time of charge off and only expected eventual net loss is used as the basis for deduction on the sales tax return.

b. Reduce the amount obtained in (a) by the amount of carrying charge included as determined by average percentage obtained in (2). Thus, carrying charge element included in net charge off is eliminated.

c. Reduce the result obtained in (b) by the percentage determined in (1). Thus, the gross write-offs for the quarter have been adjusted for nontaxable elements and now reflect the allowable bad debt deduction on taxable sales.

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

BAD DEBTS INCURRED BY LENDERS ON PURCHASED ACCOUNTS RECEIVABLE 0419.17

General

A retailer may sell an account receivable ("account") with or without recourse. For purposes of Regulation 1642, *Bad Debts*, "with recourse" means the retailer must reimburse the purchaser of the account ("lender") for any losses the lender suffers. "Without recourse" means the retailer has no obligation to reimburse the lender even if the lender cannot recover the full amount of the debt.

A lender who purchases an account with recourse may not take a bad debt deduction under the Sales and Use Tax Law with respect to any loss it suffers on that account (i.e., uncollectible debt for which it fails to obtain reimbursement from the retailer). However, a retailer who sells an account with recourse may take a bad debt deduction for the amount of uncollectible debt for which the retailer actually reimburses the lender pursuant to their contract, to the extent that such loss represents amounts on which the retailer reported and paid tax.

Regulation 1642 generally applies to bad debt losses incurred on accounts created as a result of retail sales of tangible personal property for which the retailer remitted California sales or use tax. Regulation 1642 subdivisions (h)(3) and (i) apply when the accounts at issue are held by an entity affiliated with the retailer, or by a lender.

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

Indirect Loans

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

Direct Loans

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

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

A lender making a direct loan might qualify for a bad debt deduction or refund under Regulation 1642 subdivisions (h)(3) and (i). However, no deduction or refund is allowable unless and until the lender and the retailer who paid the tax file the election as explained in Regulation 1642 subdivisions (h)(3) and (i). Furthermore, Regulation 1642 subdivisions (h)(3) and (i) applies only when the lender has purchased the account directly from the retailer, or when the lender holds the account pursuant to the lender's contract directly with the retailer. Thus, even if a lender providing a direct loan can convince the retailer to sign an election agreement, that does not automatically mean the losses on the account will qualify for deduction or refund under Regulation 1642 subdivisions (h)(3) and (i). All the requirements of Regulation 1642 subdivisions (h)(3) and (i) must be satisfied for the lender to claim a bad debt deduction or refund.

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

Refinanced Loans

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

Securitization of Loans

Securitization is a structured finance process that distributes risk by aggregating assets in a pool (often by selling assets to a special purpose entity) then issuing new securities backed by the assets and their cash flows. The securities are then sold to investors. The securitization process through an affiliated family of the lender generally will not preclude the lender or designated affiliate from qualifying for the lender bad debt deduction or refund so long as the right to claim the lender bad debt deduction or refund was not assigned beyond the designee of the lender.

With respect to sales of assets within the affiliate family, provided the securitization process occurs entirely within the affiliate family, the process generally does not affect the original lender's ability to claim or assign the bad debt deduction or refund. Further, the sales of the assets within the affiliate family do not constitute payments, credits or collections on a worthless account for purposes of Regulation 1642(d), provided that the sales of the assets occur prior to the accounts being found worthless and charged off for income tax purposes. When all of the sales of the assets occur prior to the accounts being found worthless and charged off for income tax purposes, the securitization process does not result in any taxable collections on accounts subject to the bad debt deduction. If, on the other hand, any assets were sold after they were found worthless and charged off for income tax purposes, that would be a recovery that must be reported by the lender and the applicable sales or use tax paid to the California Department of Tax and Fee Administration (CDTFA).

Claims for Refund on Sales and Use Tax Accounts
Certificate of Registration—Lender Attribute (Formerly SL Accounts)

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

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

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

Election Agreements

To claim a deduction or refund of tax, the retailer who reported the tax and the lender are required to prepare and retain an election signed by both parties designating which party is entitled to claim the deduction or refund of tax previously paid by the retailer on the worthless account. Persons entitled to claim bad debt losses are not required to file the elections with the CDTFA; instead, they must maintain a copy in their records to support any claimed refund or deduction.

The elections are subject to examination and verification by CDTFA staff to determine if they comply with the requirements of Regulation 1642. Elections that do not contain all of the required elements may be disallowed along with all deductions or claims for refund associated with such elections.

For accounts under audit, a completed CDTFA-122, *Waiver of Limitation*, will hold the statute of limitations open for the filing of a claim for refund and the obtaining of elections, if necessary.

Audit Procedures

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

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

  The software applications have inherent limitations related to human error, retroactive changes, user specific issues and other factors. In particular, the costs associated with repossessions have been found to be a troublesome area for these applications. The auditor may wish to consult a Computer Audit Specialist for assistance;
- Verify the accuracy of deductions or claims for refund;
- Confirm the records provided adequately support the claim for deduction or refund;
- Verify the amount of tax the retailer collected from customers was remitted during the period of the original sale with a spot check of the system; if the retailer has not paid the tax to the CDTFA, the auditor should not allow the refund regardless of whether the lender wrote off the bad debt;
- Ensure the records provided by the claimant are complete, as required by Regulation 1642(e);
- Confirm that the lender holds a Seller's Permit or a Seller's Permit with a Certificate of Registration – Lender attribute;
- Confirm that there is a valid election agreement on file specifying the claimant is the person entitled to claim the deduction or refund for that account;
- Confirm the signed elections contain all of the prescribed elements;
- Verify local and district tax deallocation from the jurisdiction that received the original local or district tax allocation;

- Verify the effective date provided in each election. If no effective date is specified, presume the election applies only to lender bad debt losses incurred after the later of the date the lender or retailer signed the election. The effective date provides the time period for which the bad debt losses have been assigned. The terms/dates of each election should be reviewed on a case-by-case basis;
- Ensure all claimed bad debts have been found worthless and charged off in accordance with applicable income tax provisions on the appropriate income tax returns before any bad debt deduction or refund is permitted, provided the retailer or lender has filed its income tax return at the time of the audit; and
- Provide *detailed* comments in CROS and related audit work papers pertaining to the methodology used in verifying the taxpayer's computation of the lender bad debt loss.

Auditors must include in the general comment section of the audit report or in CROS a comment as to whether the deduction or claim for refund qualifies under either Regulation 1642 subdivisions (h)(3) or (i). Both the lender's and retailer's accounts must be identified indicating whether the bad debt loss was claimed as a deduction or the taxpayer filed a claim for refund, the basis of the claim (Regulation 1642 subdivisions (h)(3) or (i)), and the periods covered. The audit must include a review of the election agreement(s) to ensure each election is valid under Regulation 1642 subdivisions (h)(3)(A), (i)(3), or (i)(4)(A), as applicable, and pertains to the transactions under audit. Regardless if sampling is used, the lender must retain an election on each account being claimed as a bad debt deduction or refund.

In addition to the verification of write-offs and recoveries, field examination must include a review of possible use tax liabilities. This review is critical to educate taxpayers regarding use tax and ensure taxpayers have reported all tax liabilities before claim for refunds are approved. The audit report must include a "use tax" comment.

For a lender to claim a bad debt deduction or refund, Regulation 1642(i)(2)(B) generally requires that "the account must have been found worthless and charged off by the lender for income tax purposes or, if the lender is not required to file income tax returns and the lender's income is not reported on another person's return, charged off in accordance with general accepted accounting principles." If the account is charged off by the lender for income tax purposes, the lender must use an approved method for charging off the debt, such as the "conformity method" or other method approved by the Internal Revenue Service. Auditors should reconcile the amount of the bad debt loss claimed on the income tax return(s) with the amount claimed as a deduction or claim for refund in the period(s) under examination. The lender should be asked to provide documentation or otherwise assist in reconciling any differences; however, auditors should expect differences in these amounts since the claimant's income tax return bad debt amounts will include losses that may not be the basis of the bad debt sales tax deductions or refunds for a variety of reasons.

The standard practice of the lending/financial industry requires bad debts to be written off after being past due for a prescribed number of days or missed payments regardless of any collection activity or payment arrangements made with the debtor, and without regard to whether the account is actually worthless. However, in order to be deductible for sales and use tax purposes, the account must generally be charged off for income tax purposes.

The bad debt deduction or refund is permissible only on the amount that was charged off for income tax purposes. In addition, auditors should review the lender bad debt losses for any subsequent sales of the bad debts, such as the lender selling the bad debts on a secondary market and recording the sale as either cash or as an accounts receivable, as these would be a recovery that must be reported by the lender and the applicable sales or use tax paid to the CDTFA.

Audit staff must obtain and review transaction level detail to determine the recommended amount of the claim to approve/allow. This includes source or detail information to show the amount of tax that was collected by the retailer on the original transactions. (See below under "Bad Debts Claimed by Credit Card Issuers" for exceptions pertaining only to credit card issuers.)

Elections must be retained by both the retailer and the lender for all bad debts claimed as a deduction or included as part of a claim for refund. When a statistical sample is to be performed in review of a deduction or claim for refund and a specific election is missing or not available, the claimant should be allowed an opportunity to obtain the proper election. However, special attention should be paid to the effective date of the election agreement.

A valid election agreement contains a binding commitment for both parties to furnish any and all documentation requested by the CDTFA to support the deduction(s) or refund(s) claimed. This includes source or detail documents to show the amount of tax that was collected by the retailer on the original transaction.

It is important to note that while it may be presumed that tax charged on an invoice was remitted by the retailer, it is imperative that audit staff determine the amount of tax charged on the transaction being claimed as a bad debt by a review of transaction level detail. The fact that the deduction or claim for refund pertains to a known retailer whose transactions are almost exclusively subject to tax is insufficient to support the deduction or claim for refund as all retailers encounter non-taxable transactions (e.g., sales of gift cards, property shipped to an out-of-state address, or even property purchased at a location outside the state). Further, the source documentation is essential in determining the proper deallocation of local and district taxes where applicable.

Computing the Amount of the Bad Debt Loss

A lender must provide a listing of all transactions (electronic or hard copy) for which it claims a bad debt deduction or refund, and they are required to provide source documents as described in Regulation 1642(e), when requested by the CDTFA staff. Transactions should be selected for review based on the auditor's discretion and not that of the lender. The amount of the bad debt for which the claim for deduction or refund is filed frequently includes some nontaxable elements (e.g., taxes, vehicle license and registration fees, earned or unearned interest, late fees, etc.). It would be highly unusual for a lender to be entitled to a bad debt deduction for the entire amount of its losses on an account. Rather, the lender must adjust the amount of its losses so that a claimed deduction or refund includes only the allowable taxable amounts. There are three basic methods of verifying the lender's claim for a bad debt deduction or refund: Actual Basis, Statistical Sampling and Mean Allowable.

Regardless of the method used, the claimant should retain and have available for review, election agreements on each account being claimed as a bad debt even if sampling is being used. In addition, prior to beginning verification of the deduction or claim for refund, when sampling is being used, all claimants should be informed that it might later be necessary to expand the size of the sample to ensure a representative sample is taken so the accuracy of the deduction or claim for refund is assured. *A claimant must be able and willing to provide documentation to support all transactions included in the deduction or claim for refund, regardless of accessibility, except for credit card issuers, as discussed below.* Transactions must be disallowed for claimants, other than a credit card issuer, that are not able and willing to provide supporting documentation, even in cases where the claimant purports to have documentation but cannot provide copies because they are not readily accessible.

1. **Actual Basis:** The lender provides a listing of accounts on an actual basis and computes the amount of the allowable bad debt loss on each account on a transaction-by-transaction basis. The information included in the listing must include the items in Appendix 2 of Regulation 1642, Bad Debts. Under this method, the lender computes the claimed bad debt loss for sales and use tax purposes on an actual basis and the auditor verifies the accuracy of the lender's listing. Auditors should utilize statistical sampling techniques to verify the accuracy of the lender's claimed refund. Auditors must follow the guidelines for performing a statistical sample set forth in Chapter 13, *Statistical Sampling*. For additional guidance related to sampling refund populations see section 1305.10.
2. **Statistical Sampling:** The lender provides a listing of the bad debt accounts written off per their books but they have not computed the allowable bad debt loss as described in Regulation 1642(d). The amount listed may include non-taxable elements such as taxes, vehicle license and registration fees, interest, late fees, repossession fees, etc. The auditor must perform a statistical sample of the transactions to compute the allowable portion of the bad debt loss. Team members must follow the guidelines for performing a statistical sample set forth in Chapter 13. For additional guidance related to sampling refund populations, see section 1305.10. The lender must provide a listing for the sample that computes the allowable portion of the bad debt on a transaction-by-transaction basis in accordance with Regulation 1642(d). The auditor must verify the accuracy of the sample data.

   Under this method, the lender provided the total write-off amount for the population. It includes items not allowable under Regulation 1642. The sample is used to compute an audited allowable amount on a transaction-by-transaction basis. Thus, every transaction examined in the sample will show a difference between the audited and claimed bad debt. These differences must be evaluated using CDTFA's Statistical Sampling Evaluation program. When the sample evaluates well, it will be used to compute an audited allowable bad debt percentage. The allowable bad debt percentage is the audited allowable amount per the sample (computed in accordance with Regulation 1642) divided by the total bad debt claimed in the sample. The allowable bad debt percentage will be applied to the total claimed bad debt to arrive at the total audited allowable bad debt amount. If the sample differences do not evaluate well, team members should consider expanding the sample. Before expanding a sample in this situation, a Computer Audit Specialist should be consulted.

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

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

The alternate procedure, described below, may be used when reviewing and examining deductions or claims for refund filed by certain lenders with respect to credit card bad debts where the lenders do not maintain transaction level detail.

Bad Debts Claimed by Credit Card Issuers

Certain lenders, such as credit card issuers, are affiliated with or otherwise maintain a contractual relationship with the retailer who sold the merchandise, but do not maintain transaction level detail in the ordinary course of business. Such lenders (credit card issuers) that have deducted or filed a claim for refund on credit card bad debts under Regulation 1642 may not have secured all the required election agreements. They also may not maintain or have available sales transaction level detail (i.e., source documents showing the retailer's sales to its customers on a transaction level basis, such as bills, receipts, invoices, cash register tapes, or other documents of original entry, as well as the sales/use taxes charged on the specific transaction by the retailer) in support of the aged bad debt write-offs. In general, most such lenders maintain credit history transaction level detail (also known as statement level detail) in their records and not sales transaction level detail.

Therefore, these alternate procedures are specific with regard to the election agreements and the review of transaction level detail. These alternate procedures may be used in addressing the examination and verification of lender bad debt deductions or claims for refund where the lenders do not maintain sales transaction level detail. The procedures apply to all such lender bad debt claims regardless of when the deduction was taken or the claim for refund was filed.

Notwithstanding the provisions of Regulation 1642, for all lender credit card bad debt deductions or claims for refund, the CDTFA will allow the lender to secure and provide any missing elections in support of their bad debt deductions or claim for refund. However, special attention should be paid to the effective date on each election agreement that is secured after the deduction or claim for refund has been filed/claimed. Where questionable, the election should be verified with the retailer or assignor.

In addition, although sales transaction level detail may not be maintained by the lender, lenders must still provide credit history transaction level detail for each account being written off and claimed as a bad debt for sales tax purposes. Credit history transaction level detail will provide, by customer, items included in the bad debt write-off such as principal, interest, and late fees, as well as other nontaxable charges based on the lender's written agreement with the customer. Since only the principal amount is used to compute the amount on which a tax refund may be allowed, these other charges (e.g. late fees, penalties, interest, etc.) must be removed. The principal amount will generally include both taxable and nontaxable sales, as well as any sales taxes charged. Therefore, auditors must determine whether the principal amount includes sales taxes before making any adjustment for tax included. Credit history transaction level detail will show both charges made to the specific customer's credit account and payments made by the customer on that account. Credit history transaction level detail is important because it is used to verify the computation of the bad debt.

Lenders claiming credit card bad debts may compute their bad debts using one of the following methods:

1. **Taxable Sales Percentage Method (Exhibit 21)**. This method incorporates the principles of AM Section 0419.15, "Bad Debts for Department Stores Using Formula under Regulation 1642 in Determining Sales Tax Credit for Bad Debts – Contract Method." The lender and retailer do not provide sales transaction level detail by customer if this method is used; but must provide credit history transaction level detail.

   Under this method, the lender is required to obtain and retain a yearly statement from each retailer for whom a bad debt loss is being claimed, showing the retailer's California taxable sales percentage for that calendar year. The retailer's statement should also include the name and contact information of the person providing the taxable sales percentage. The taxable sales percentage is subject to verification by the CDTFA. Auditors must determine if the provided taxable sales percentage includes sales taxes. The taxable sales percentage will be applied by year, to each retailer's principal bad debt amount, to compute the allowable bad debts for sales tax purposes.

2. **Sales Transaction Level Detail Method.** If the lender does not use the Taxable Sales Percentage method above, then this method must be used. It requires the lender and retailer to provide sales transaction level detail records by customer for the bad debts being written off. The bad debts will be computed using one of the methods identified in the section "Computing the Amount of the Bad Debt Loss." Once the percentage of taxable sales is computed using one of the testing methods, this percentage will be applied to the principal amount to compute the allowable bad debts for sales tax purposes.

   Auditors must determine if the principal amount includes or excludes sales tax. Adjustments must be made for sales tax if the principal amount includes tax.

It is the lender's responsibility to provide credit history transaction level detail, as well as documentation to support the amount of the total bad debt write-off per year, the amount of total bad debt write-off per merchant/retailer (as applicable), and evidence that the bad debt was actually written off for income tax purposes or, if the lender is not required to file income tax returns, charged off in accordance with generally accepted accounting principles. It is also the lender's responsibility to provide documentation on any subsequent bad debt recoveries or subsequent sales of accounts receivable which were written off, (e.g., accounts receivables sold on the secondary market). Therefore, despite the exception with respect to the examination of sales transaction level detail, all other audit verification procedures relating to bad debts will remain the same and any alternative method to compute the bad debt deduction or refund will be subject to review, testing and approval by the CDTFA.

Required Documentation – Vehicles

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

Total Population of Claim on Electronic Media

- Must exclude or readily identify loans that do not qualify
- Must identify loan origination date (typically date loan contract entered into)
- Must include seller's/dealer's name and address (city and state)
- Must include the seller's/dealer's California seller's permit number
- Must include consumer's name and address (city and state)
- Must include the following additional information:
    - Reference number – number assigned to each loan
    - Type of vehicle/property – for example, vehicle, RV, mobile home, etc.
    - Full VIN – in case secondary verification with DMV records is required
    - Date of repossession charge off – the date charged off for income tax purposes
    - Loan number – actual loan account number
    - Charge off or loss per records – amount charged off for income tax purposes
    - Summarized number of transactions in each local tax and district tax area

Complete contract files must be available for Sample Selection

- Team members must follow the guidelines for performing a statistical sample set forth in Chapter 13.
- For each loan in the sample — evidence that the uncollectible portion has been charged off for income tax purposes or in accordance with Generally Accepted Accounting Principles (GAAP). Printouts from the taxpayer's accounting system will suffice.
- For losses claimed under Regulation 1642(h)(3) and (i), an election agreement for each loan, as required by Regulation 1642 (i)(3)(A) and, if applicable, the election agreement required by either Regulation 1642 (h)(3)(A) or (i)(4)(A).

Documentation and Information for Selected Sample

- Full VIN
- Complete contract file, including the "No Recourse" statement. If "No Recourse" statement is not available, copy of the contract/agreement between dealer and the financial institution establishing that the lender holds the account without recourse.
- Reference number – number assigned to each loan
- Loan origination date – date contract entered into
- Date of repossession charge off – the date charged off for income tax purposes
- Loan number – actual loan account number
- Sales price of vehicle – total amount subject to tax including document preparation charge and taxable smog
- Nontaxable charges such as charges for optional maintenance/service contracts, Smog Fee Impact, Smog Certificate fee, etc.
- Sales Tax – Tax reimbursement collected from the consumer on sale
- Vehicle License Fee
- Insurance – net amount
- Down payment
- Any adjustments to the principal
- Finance charges – net amount
- Payments on principal
- Value of repossession – sales price for subsequent sale
- Charge off or loss per records – amount charged off for income tax purposes
- Repossession expense – auctioneer's fees, reconditioning, etc.
- Recovery – payments made after the loan is charged off on records
- Reversals – adjustments for non-sufficient funds (NSF) checks, etc.
- Taxpayer must compute the amount of refund per Regulation 1642

Local and District Tax Verification

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

Reserve Accounts

In the case of a loan purchased by a lender from an automobile dealer who sold a vehicle at retail and reported tax on that sale, often, to offset any losses that may be incurred by the lender as a result of a purchaser/borrower's default on the loan, the lender remits a portion of the principal to the dealer and retains the remainder in a reserve account. "Principal" refers to the proceeds of the sale of the loan from the dealer to the lender. The remaining principal in the reserve account typically is transferred by the lender to the auto dealer within one to three months after the transaction date.

When an auto loan sold to a third-party lender becomes uncollectible, the lender typically charges the reserve account for some or all of the outstanding balance that the purchaser/borrower failed to pay on the loan. In such circumstances, the loan is considered to be sold with recourse.

If a loan was sold with recourse, Regulation 1642, *Bad Debts*, subdivision (h)(1)(C), provides that the auto dealer may be entitled to claim a bad debt deduction or refund to the same extent as if the loan had not been sold. In the reserve account scenario, the amount of the bad debt loss is measured by the amount of the reduction to the lender's reserve account with respect to the unpaid amount upon which tax has been paid. However, the allowable bad debt deduction would exclude any nontaxable receipts, such as amounts allocable to interest, insurance, repair or installation labor as provided in Regulation 1642, subdivision (b).

Disputed Claims for Refund

In cases where the lender, retailer or affiliate (taxpayer) disagrees with staff's findings regarding the disallowance of certain types of transactions or the amount of the allowable bad debt loss, the ADRS will process the concurred portion (net of debits) of the claim for refund only. The taxpayer will receive a Notice of Refund with an accompanying remittance for the concurred portion of the refund claim while the nonconcurred portion of the claim will be forwarded to the Legal Division, Appeals Bureau, when applicable.

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

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

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

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

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

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

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

SHIPMENT BY MAIL OR COMMON CARRIER TO INDIAN RESERVATIONS 0419.22

Generally, sales tax applies on sales of tangible personal property by an off-reservation retailer to an Indian on an Indian reservation when the property is delivered by mail or common carrier unless the following three conditions are met:

1. The contract of sale (or equivalent document) must include a statement expressly requiring delivery on the reservation (F.O.B. reservation).
2. Title cannot pass prior to the time the merchandise is delivered to the Indian purchaser on the reservation.
3. The goods must in fact be delivered directly to the Indian purchaser on the reservation.

When all three conditions are met, the transaction qualifies as a sale on the reservation even if the transportation documents, such as a bill of lading, do not state that the delivery is at destination (F.O.B. reservation), provided the transportation documents do not contain any language contradictory to the language contained in the contract of sale.

For example, if the contract of sale contains a clause passing title on the reservation and an F.O.B. reservation clause, and the transportation document is silent regarding F.O.B. or otherwise does not indicate delivery is at destination, the transaction will qualify as a sale on the reservation provided the three conditions listed above are met. However, if the contract of sale contains a clause passing title on the reservation and an F.O.B. reservation clause, but the transportation document contains an F.O.B. origin clause, the documents would contradict each other and the sale would be deemed to occur at the time the retailer transfers the property to the shipper. Accordingly, the transaction will be subject to sales tax even when the above conditions are met.

PROPERTY USED IN TRIBAL SELF-GOVERNANCE BY TRIBES WITHOUT RESERVATION FACILITIES 0419.24

Generally, sales tax applies to sales of tangible personal property by an off-reservation retailer to an Indian when ownership of the merchandise is transferred to an Indian purchaser outside Indian country. However, Sales and Use Tax Regulation 1616, *Federal Areas*, subdivision (d)(4)(G), provides a sales and use tax exemption for sales of property used in tribal self-governance. To qualify for the exemption, all of the following criteria must be met:

1. The sale must be to a tribal government of an Indian tribe that is officially recognized by the United States,
2. The tribal government's Indian tribe does not have a reservation, or the principal place where the tribal government meets to conduct tribal business is not on the reservation because the reservation does not have a building or lacks essential utility services necessary to meet and conduct tribal business,
3. The property is purchased by the tribal government for use in tribal self-governance, and
4. Title to the property transfers and the property is delivered to the tribal government at the principal place where the tribal government meets to conduct tribal business.

To verify the address where title to the property will transfer is valid, a list that contains eligible tribal governments along with the address outside Indian country where they meet to conduct tribal business is available on CDTFA's webpage. The list of the tribal meeting locations is available at https://www.cdtfa.ca.gov/industry/indianLandSales.htm.

To support the exempt sale, retailers should obtain an exemption certificate from the tribal government as supporting documentation. Tribal governments may use Form CDTFA-146-TSG, *Exemption Certificate – Property Used in Tribal Self-Governance and Statement of Delivery*, as part of the necessary documentation to retailers that the sale meets the criteria for the exemption.

TAX PAID PURCHASES RESOLD 0419.25

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

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

Original purchase price	$500.00	500.00
Tax paid 7.25%	36.25	36.25
Subsequent sales price	500.00	700.00
Sales tax 7.25%	36.25	50.75
Allowable deduction	500.00	500.00

Exceptions to this policy are:

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

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

AUDIT OF CHARITABLE ORGANIZATIONS 0419.30

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

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

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

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

AUDITING TRANSPORTATION CHARGES 0419.35

Revenue and Taxation Code section 6012, (see also Regulation 1628, *Transportation Charges*), provides that the amount of transportation charges excluded from the measure of tax shall meet the following requirements:

If transported by a common carrier:

- The transportation charge is separately stated in the invoice, bill, statement, contract, etc.;
- The transportation is from the retailer's place of business or other point from which shipment is made directly to the purchaser;
- The transportation charge does not exceed the cost of the transportation to the retailer.

If transported by the retailer or property sold for a delivered price:

- The transportation charge is separately stated in the invoice, bill, statement, contract, etc.;
- The transportation is from the retailer's place of business or other point from which shipment is made directly to the purchaser;
- The charges are reasonable; and
- Title to the property has passed to the purchaser prior to such transportation.

The exclusion of transportation charges is determined on a transaction by transaction basis. Transportation charges are regarded as separately stated only if they are separately set forth in the contract of sale or other document issued at the same time as the sale. The retailer's records supporting their nontaxable transportation charges must be maintained on a transaction by transaction basis in order to claim an exemption.

When verifying claimed nontaxable transportation charges, auditors should determine whether the taxpayer accounts for these charges on a transaction by transaction basis. If the taxpayer accounts for transportation charges on a transaction by transaction basis, then the auditor may test those charges. The results of the auditor's test may be projected for all periods within the audit for which transportation charges are supported by records on a transaction by transaction basis.

If the taxpayer does not account for transportation charges on a transaction by transaction basis, then the charges should not be tested. The entire claimed nontaxable transportation deduction is subject to tax. If documentary support on a transaction by transaction basis is provided for a limited period, e.g., three quarters of the audit period, only that period will be considered; the deduction for all unsupported quarters will be disallowed.

NOTE: This section does not apply to transportation of landfill material. See Regulation 1628, subdivision (c) if auditing transportation charges involving landfill material.

NEW OR REMANUFACTURED TRUCKS, TRUCK TRACTORS, TRAILERS, OR SEMITRAILERS 0419.45

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

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

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

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

To file the affidavit, the purchaser should use Form CDTFA–837, *Affidavit for Section 6388 or 6388.5 Exemption from the CA Sales & Use Tax* (Exhibit 11). Alternative documentation is permissible as long as it contains all the information required by Form CDTFA–837.

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

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

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

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

1. A trailer that is manufactured or remanufactured outside California must be removed from California within 30 days from the date of delivery; or a trailer that is manufactured or remanufactured within California must be removed from California within 75 days from the date of delivery.
2. If the trailer is registered outside the state, the purchaser or purchaser's agent provides the delivering manufacturer, remanufacturer, or dealer a copy of the current out-of-state license and registration for the trailer showing the VIN or serial number; or, if the trailer is registered in-state under the PTI (Permanent Trailer Identification) program, the purchaser or purchaser's agent provides the delivering manufacturer, remanufacturer, or dealer a copy of the federal document assigning or confirming the purchaser's or lessee's USDOT (United States Department of Transportation) number, FMC (Federal Maritime Commission) number, or a copy of the current SSRS (Single State Registration System) filing with the DMV. A purchaser or purchaser's agent may not use an FMC number if the purchaser has a current USDOT number. Evidence of registration outside California must be submitted to the dealer, manufacturer, or remanufacturer no later than 60 days after the timely providing of an affidavit described in subdivision 1620.1(b)(3)(A)3. Evidence of a USDOT number, FMC number, or SSRS filing must be submitted with the affidavit. [Descriptions of the PTI, USDOT, FMC, and SSRS programs are described in Regulation 1620.1(a).]
3. The purchaser or purchaser's agent must also provide a valid affidavit to the manufacturer, remanufacturer, or dealer, stating:
    a. a.The name and location of the dealer from whom the trailer was purchased,
    b. b.The name and location of the California dealer, manufacturer or remanufacturer that delivered the trailer to the purchaser and the date of delivery,
    c. c.That the vehicle was purchased for use exclusively outside the state, or exclusively in interstate or foreign commerce, or both,
    d. d.That the vehicle was removed from the state within the appropriate time periods provided for in subdivision 1620.1(b)(3)(A)(1), and
    e. e.The date of removal.

As noted in the previous section, the purchaser must use Form CDTFA–837 (Exhibit 11) or its equivalent as the affidavit.

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

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

SALES TAX EXEMPTION FOR FOREIGN MISSIONS AND CONSULS 0419.50

In general, sales and use tax applies to the sale and use of tangible personal property sold or leased to foreign governments. However, neither sales tax nor use tax applies to sales to foreign missions or representative offices, foreign consular officers, employees, and members of their families if those persons have been granted immunity from tax according to treaties or other diplomatic agreements with the United States.

Mission and Official Tax Exemption Cards – Diplomatic tax exemption cards labeled "Official Purchases Only" are issued by the U.S. Department of State, Office of Foreign Missions (OFM) to foreign missions and by the American Institute in Taiwan (AIT) to representative offices (such as the Taipei Economic and Cultural Representative Office in the United States and the Taipei Economic and Cultural Offices) for use when making official purchases. The person whose name and photo appear on the card is the mission's or representative office's point of contact and is responsible for ensuring the accuracy of the exemption. This individual does not need to be present when purchases are made in the name of the mission or representative office. Official purchases must be paid in a form of payment bearing the name of the foreign mission or representative office. Such forms of payment include official checks, official credit cards, or electronic funds transfers (automated clearinghouse debits, automated clearinghouse credits, or wire transfers). Cash, credit cards or personal checks in the name of the bearer of the mission tax exemption card cannot be used as payment.

Personal Tax Exemption Cards – Diplomatic tax exemption cards labeled "Personal Tax Exemption" are used by eligible foreign mission and representative office members and their dependents to obtain exemption from sales or use tax on personal purchases. The card is not transferable and must be used solely for the benefit of the individual identified and pictured on the card. Acceptable forms of payment include cash, credit cards or personal checks in the name of the bearer of the personal tax exemption card.

Each tax exemption card includes the name of the person to whom it is issued, personal identification information, a photograph, an expiration date, and an identification number (e.g., PID#). The tax exemption cards also contain text on the front and back that indicate the level of exemption authorized for the cardholder. Some cards authorize an unrestricted exemption from sales taxes, and other cards authorize an exemption with some degree of restriction, such as a minimum purchase requirement, excluded categories, or both. For example, if the tax exemption card is granted for a minimum level of exemption of $100, as indicated on the card, the purchaser must purchase merchandise aggregating over $100 in a single transaction to qualify for the exemption. The total purchase may be composed of all taxable merchandise or a combination of taxable and non-taxable merchandise, i.e., a sale of cigarettes for $36 is exempt if sold together with $64 non-taxable food products. Separate purchases in the same store will not qualify if the amount of each transaction does not exceed the amount indicated on the card, even though the combination of all individual purchases in that store may exceed that amount. Examples of tax exemption cards issued by OFM and AIT are provided in Exhibit 19.

To support the exemption, the retailer must prepare and retain an invoice or other written evidence of the sale and should enter the name of the purchaser, the identification number, the name of the foreign mission or representative office, the expiration date of the card, and the minimum level of exemption specified on the card, if any. For official purchases, the retailer shall retain evidence that the form of payment was in the name of the foreign mission or representative office. Such payments may include official checks, official credit cards, or electronic funds transfers (automated clearinghouse debits, automated clearinghouse credits, or wire transfers).

Questions regarding tax exemption cards issued by OFM may be made by telephone to the OFM at (202) 895-3500 x2. Questions regarding tax exemption cards issued by AIT may be made by telephone to the AIT at (703) 525–8474.

Tax exemption cards alone may not be used for exemption from taxes imposed on sales of vehicles. For special rules regarding sales of vehicles, see AM Chapter 6, "Vehicle, Vessel and Aircraft Dealers."

AUDIT OF ELECTRONIC BENEFIT TRANSFER (EBT) CARD PURCHASES 0419.60

GENERAL

The Electronic Benefit Transfer (EBT) program is the system used for the delivery, redemption, and reconciliation of two types of public assistance benefits in California:

1. Those issued by the United States Government (USG), specifically, CalFresh benefits (formerly food stamps, see AM section 0904.30); and
2. The State-authorized cash aid benefits (state welfare benefits programs, such as CalWorks and General Assistance).

Recipients of public assistance access their issued benefits with an EBT card which is similar to a "debit card." Paper food stamps have been replaced by the EBT card. The EBT program is administered by the California Department of Social Services and the state's counties.

EBT PROGRAM

Counties are responsible for administering certain federal and state public assistance benefits programs. The EBT program allows counties to provide cash benefits to recipients via EBT cards. CalFresh and state-authorized cash aid benefit recipients can use their EBT card at point-of-sale terminals at participating retailers that are authorized to process these transactions. At the time of a purchase with the EBT card, the recipient must select either their CalFresh account or the state-authorized cash aid benefit account from which payment will be made.

PRODUCTS PURCHASED WITH AN EBT CARD – CALFRESH BENEFITS

Products which are *eligible* to be purchased with CalFresh benefits and are so purchased are not subject to the sales and use tax (Regulation 1602.5(c)). Products which are normally taxable, but are exempt when purchased with CalFresh benefits include among other things: non-alcoholic carbonated beverages, food coloring extract, ice, etc. This deduction will normally be found when auditing grocery stores; however, it could be claimed by mini-marts, liquor stores, drugstores with food sections, and other retailers which are eligible to accept an EBT card.

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

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

RESTAURANT MEALS PROGRAM

General

The Restaurant Meals Program (RMP) is an optional county-administered program that allows *eligible* CalFresh recipients to use their CalFresh benefits via their EBT card to purchase hot prepared food products at participating low-cost restaurants in certain counties within the state. The RMP enables elderly (over 60 years of age), disabled and homeless individuals and their spouses receiving CalFresh benefits to use their EBT card to purchase meals from participating restaurants. For all other CalFresh recipients, the federal rules preventing the purchase of prepared food still apply. The RMP does *not* apply when recipients use state-issued cash aid benefits to pay for hot prepared food products.

Counties offering the RMP are responsible for certifying the eligibility of recipients of CalFresh benefits and for informing the RMP recipients of names and addresses of participating restaurants. The participating counties determine the recipients' eligibility to the program and code their EBT card so that it may be accepted as payment for meals at participating restaurants. The EBT card has to be presented prior to ordering a meal from an approved restaurant so the restaurant can verify the eligibility of the RMP recipient.

The following counties participate in the RMP as of 2016:

- Alameda,
- Los Angeles,
- San Francisco,
- Sacramento,
- San Diego
- Santa Clara,
- Santa Cruz, and
- San Luis Obispo.

Pursuant to the terms of the RMP, participating restaurants cannot charge sales tax or any other fees to individuals using their CalFresh benefits to purchase hot prepared food products. However, the terms of the RMP do not prohibit participating restaurants from charging sales tax on sales of hot prepared food products normally subject to tax, when the sales are made to individuals using state-issued cash aid benefits to purchase the hot prepared food products, and not CalFresh benefits.

Ultimately, whether tax applies to the sales of retailers participating under the terms of the RMP depends in part on whether the payment received is authorized pursuant to the CalFresh benefits program, or the payment received is authorized pursuant to a state-issued cash aid program, which represents a sale to the State of California.

CalFresh RMP – Sales to the United States Government (USG)

The sale of hot prepared food products to CalFresh benefits recipients eligible for the RMP who use an EBT card to authorize payment for the hot prepared food products may qualify as a sale to the United States Government (USG) provided the following conditions are met. To qualify as a sale to the USG:

1. The CalFresh benefits recipient must be an authorized EBT cardholder,
2. Both the CalFresh recipient and the retailer must be eligible to participate in the RMP, and
3. The CalFresh recipient must select their CalFresh benefits to authorize payment for the sale of the hot prepared food products.

Provided all of these conditions are satisfied, the sale of hot prepared food products qualifies as a sale to the USG, and tax does not apply to the sale. To support a claim that tax does not apply to the sale, the retailer is required to obtain evidence of direct payment by the USG. Evidence of direct payment by the USG includes sales receipts which indicate either “Supplemental Nutrition Assistance Program” or “SNAP” or bank statements listing electronic funds transfers to the taxpayer as either “Supplemental Nutrition Assistance Program” or “SNAP.”

State-issued Cash Aid Benefits Program (CalWorks, Public Assistance, etc.)

When a qualifying individual selects the state-issued cash aid benefits account to authorize payment for the sale of hot prepared food products, a sale to the state occurs. There are no general exemptions from tax to sales of tangible personal property to the state. Tax applies to sales of hot prepared food products to the state as the sale of tangible personal property generally, regardless of whether the retailer is eligible to participate in the RMP.

In some cases, qualifying individuals using their public assistance benefits at RMP participating restaurants may combine their CalFresh benefits and state-issued cash aid benefits on their EBT card to cover the purchase of hot prepared food products. When payment is made partly with CalFresh benefits, and partly with state-issued cash aid, only the portion of the gross receipts that represents a sale to the USG (CalFresh benefits) is subject to an exemption from tax. The remaining amount represents a sale to the state and as such is subject to tax. The retailer is required to identify in its records the taxable and nontaxable portions of its sales and maintain written evidence documents showing direct payment by the USG.

FEDERAL EXCISE TAX 0419.65

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

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

AUDIT OF LEASES 0420.00

GENERAL 0420.05

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

AUDITING PROCEDURE 0420.10

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

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

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

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

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

TIMELY ELECTION 0420.15

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

ITEMS INCLUDED IN RENTAL RECEIPTS 0420.20

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

- **LICENSE and ROYALTY CHARGES.** If a rental or lease agreement calls for a royalty to be paid based on units produced or for use of the property, such royalties are includable in rental receipts. For example: a computer company sells pre-written software in a taxable transaction. Charges for site license fees that permit purchasers to install additional copies of the program on other computers represent additional gross receipts from the original sale of the program.
- **ADVANCE RENTALS.** Advance rental payments received by the lessor at the time the lease commences are subject to the tax at the time the amounts are paid by the lessee. It is immaterial that the advance rental payment is designated as applicable to the final period of the lease. Generally, if the amount collected at the commencement of a lease is designated as a "security deposit" rather than an advance rental, the amount collected would not be subject to tax until it is actually applied to a rental payment.
- **CHARGES DESIGNATED AS INTEREST.** When equipment is actually leased and not sold on credit, the amounts designated by the lessor as interest which are payable by the lessee, in addition to amounts designated as rentals, are includable in the rental payments subject to tax.
- **PROPERTY TAX.** When a lessee is required by the rental contract to pay for any personal property taxes assessed on the lease property, such amounts are regarded as part of the taxable rental receipts whether the personal property tax is assessed directly against the lessee or the lessor. (Exception: Personal property taxes are not included in rental receipts when assessed against personal property where a bank or financial corporation is the lessor and pays in lieu franchise tax on net income to California. The California Franchise Tax Board maintains a listing of banks and financial corporations that pay in lieu tax.)
- **MANDATORY CHARGES.** When the lessee is obligated under the lease contract to use services provided by the lessor such as equipment maintenance, warranty, assembly, disassembly, etc., such additional charges are includable in rental receipts. However, if the lease contract merely requires that the lessee maintain the property, the lessee's maintenance costs are not includable in rental receipts.

  Another example of mandatory charges is the collision damage insurance supplement offered generally by daily car rental companies. If it is required that the customer purchase the insurance as part of the rental agreement, such charges are includable in rental receipts.
- **DEFICIENCY CHARGES.** These charges generally represent the difference between the actual value of the property returned to the lessor by the lessee at the termination of the lease and the value of the property prescribed in the lease contract upon which the periodic rentals were based. Such additional deficiency charges are includable in rental receipts. On the other hand, credits to lessees represent a reduction in rental receipts if these adjustments are called for in the lease contract.
- **DELIVERY CHARGES.** In those circumstances where delivery of tangible personal property is made by facilities of the lessor (as distinguished from an independent contract carrier), the delivery charge is included in the measure of tax unless the transportation occurs after possession of the leased property is transferred to the lessee or after the right to possession is granted to the lessee and the delivery charges are separately stated.

  Charges for delivery made by an independent contract carrier may also be taxable where the sale is made for a delivered price.

- **RETURN TRANSPORTATION CHARGES.** Transportation charges at the termination of a lease for return of rented property from the lessee to the lessor are subject to tax unless the lessee has the option to provide his own return transportation. Such charges must also be separately stated and not be included with delivery charges in order to be exempt.

ITEMS EXCLUDED FROM RENTAL RECEIPTS 0420.25

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

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

SALE OF LEASED PROPERTY BY LESSOR 0420.30

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

REPAIR AND MAINTENANCE CONTRACTS 0420.35

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

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

FUEL USED IN RENTAL VEHICLES "WET RENTALS" 0420.40

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

- **Lessor is Retailer of Fuel. —** When the lease of a vehicle is subject to tax as a continuing sale, the lessor is the retailer of fuel furnished under wet rentals of the vehicles. Such fuel may be purchased ex-tax under a resale certificate, and if sales or use tax is reported and paid on the total rental receipts no additional tax liability accrues.
- **Lessor is Consumer of Fuel. —** When the lease of a vehicle is not a continuing sale because tax has been paid on the cost of the vehicle, or because the vehicle is mobile transportation equipment, the lessor is the consumer of fuel furnished under a wet rental, and tax applies to the sale of fuel to the lessor. However, if the lessor makes a separate charge to the lessee for the fuel, the lessor is the retailer of such fuel and the retail sale of the fuel is subject to sales tax. In that case the lessor may purchase the fuel ex-tax under a resale certificate.

AUDIT OF SALE AND LEASEBACK TRANSACTIONS 0420.45

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

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

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

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

AUDIT OF LEASE TRANSACTIONS WITH GOVERNMENTAL BODIES 0420.50

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

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

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

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

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

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

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

AUDIT OF NONTAXABLE ELECTRONIC SALES AND PURCHASES OF COMPUTER SOFTWARE 0421.00

INTRODUCTION 0421.01

This section provides guidance regarding the uniform documentation standards and audit procedures to be used in the verification of claimed nontaxable sales and purchases of electronically transferred computer software, including software electronically transferred pursuant to a software maintenance contract, and software transferred by the "load and leave" process.

Please note: When sales and purchases of electronically transferred software do not include the transfer of tangible personal property, the Technology Transfer Agreement provisions of the Revenue and Taxation Code do not apply.

Sales of prewritten software and software maintenance contracts are not taxable transactions if the seller transfers the software via:

1. Remote telecommunications to the purchaser's computer; or
2. Installation of the software directly into the permanent storage memory of the customer's computer, unless the installation is part of the sale of the computer.

In both cases, in order for tax not to apply, no tangible personal property, such as storage media, may be transferred in the transaction.

Software or periodic software upgrades or updates may be electronically transferred directly to a purchaser's computer over the Internet, or by a "load and leave" process.

SOFTWARE TRANSFERRED BY A LOAD-AND-LEAVE PROCESS 0421.02

A sale of software by the load-and-leave process requires the seller, the seller's employee, or the seller's agent to personally install the software directly into the permanent storage memory of the customer's computer and requires that the installation is not part of the sale of the computer. When software is transferred via load-and-leave, the seller or seller's agent must retain title and possession of the storage media containing the software during the entire installation process. Any transfer of title or possession of the storage media containing the software to the purchaser, however temporary, will render the transaction taxable. During the load-and-leave process, the period of time the seller's storage media is connected to the customer's computer is not considered a temporary transfer provided that the seller or seller's agent maintains control of the loading process and retains title to and possession of the storage media/device at all times.

SALES AND PURCHASES OF SOFTWARE TRANSFERRED ELECTRONICALLY 0421.03

Sales and purchases of software transferred electronically are not subject to tax if no tangible personal property is furnished by the seller in the transaction. In cases where tangible personal property is provided in the transaction, in any format except written documentation or manuals (including documentation or manuals in machine-readable form) designed to facilitate the use of the program, tax applies to the original electronic transfer of the software, even when the tangible personal property is shipped subsequent to the electronic transfer of the software provided that the transfer of tangible personal property is part of the original sale of the software.

However, where the software is transferred electronically, if another copy of the software is later sold to the purchaser on tangible storage media as part of a separate and distinct transaction, tax will not apply to the prior sale of the electronically supplied copy of the software. Conversely, where the software is transferred on tangible storage media, if another copy of the software is later sold to the purchaser and transferred electronically as part of a separate and distinct transaction, tax will not apply to the subsequent sale of the electronically supplied copy of the software. The determination as to whether a transaction is separate and distinct will be based on the facts and circumstances, and evaluated on a case-by-case basis.

In most cases, electronic delivery of the software will be initiated by customers by going to the seller's website to "pull" a copy of the software to their computers. In those cases, the seller will transmit an access code, or "key," that customers must use to activate the software. *An auditor should be aware that charges for the use of an access code or "key" to "unlock" software programs or features previously transferred on tangible storage media are subject to tax.* Conversely, charges for the use of an access code or "key" to "unlock" software programs or features previously transferred electronically are not subject to tax.

Some software providers may offer a cloud computing service model known as "Software as a Service," in which: (1) customers can access the software on a remote network or location, (2) customers do not receive a copy of the software, electronic or otherwise, and (3) the seller retains possession and control of the software at all times. Under these conditions, tax does not apply to charges for "Software as a Service," or similar models, such as "Platform as a Service" or "Infrastructure as a Service," in which there is not a transfer of title or possession of any tangible personal property in the transaction.

Some sellers may give customers the option of receiving the software either electronically or through the transfer on a tangible storage media. Sellers that provide such an option may maintain separate and distinct product codes, part numbers or stock keeping units (SKU) for the electronic delivery and storage media delivery modes. The seller's billing system should then add or not add sales tax reimbursement or use tax to the sale, depending on whether the product code is for the storage media version or the electronic version. The seller may have multiple software products having different distribution methods associated with each product. For instance, a particular software product may only be available to customers through electronic delivery, while another may be obtained either electronically or on storage media.

When the sale of prewritten software is a nontaxable transaction, the seller is the consumer of tangible personal property used to produce written documentation or manuals (including documentation or manuals in machine-readable form) designed to facilitate the use of the program and transferred to the purchaser for no additional charge. If a separate charge is made for the documentation or manuals, then tax applies to the separate charge. The transfer of such documentation does not make an otherwise nontaxable electronic transfer of prewritten software subject to tax.

AUDIT PROCEDURES FOR SALE 0421.04

Auditors should be mindful that the prevailing business practice in the software industry is to transfer software electronically without providing a copy of such software on tangible storage media. When reviewing claimed nontaxable sales of electronically transferred software, the auditor should conduct a review of the taxpayer's business practices, policies, procedures, and the company website (if one exists) to gain an understanding of the method(s) used to sell, transfer, or distribute software to its customers.

Staff should accept the taxpayer's claim that its sales of electronically transferred software are nontaxable when staff has conducted preliminary testing (informal spot or random tests) and found that no exceptions exist and staff is satisfied that:

- The taxpayer's policy and common practice is not to transfer a tangible copy of the software to the purchaser,
- There is no documentation to support that such transfers occurred.

Additional "controlled" testing should be conducted when exceptions exists. An auditor should always keep in mind the general auditing procedures and techniques outlined in this chapter, including short tests and cut-off techniques. One way to determine if a customer was provided with a copy of software on tangible storage media is to check for shipping charges. The absence of a charge to the customer for shipping is indicative that the software was shipped electronically. As with other types of sales, large dollar transactions may be stratified for review on an actual basis, as deemed appropriate by the auditor.

Reviewing Individual Transactions

Unless there is affirmative evidence that a copy of the software was furnished on tangible storage media in the transaction (e.g., an invoice shows shipping charges), the auditor should presume the transaction is nontaxable.

Where there is ambiguity or contradictory information/documentation regarding whether a transfer of tangible personal property occurred, the auditor should use appropriate auditing procedures to resolve the issues. The auditor may request copies of shipping documents, billing statements, or other documentation, such as invoices or purchase orders to determine whether copies of software on tangible storage media were transferred to buyers. If the underlying sales related documentation, such as the contract, purchase order, or other pertinent information supports the taxpayer's claim that the software was delivered electronically, the auditor should accept the taxpayer's claim that the sale was nontaxable. If, after examining the underlying sales related documentation, substantial ambiguity remains, as part of the audit process, the seller may use either CDTFA–504-CSW (paper version) or Form CDTFA-504-CSW1 (electronic version) – *Statement Concerning Property Purchased Without Payment Of California Sales Tax - Software*, to support its assertion that a copy of the software or software updates were not transferred to the purchaser on tangible storage media.

An auditor should not conclude that software was transferred on tangible storage media based upon the fact that a sales invoice has the "ship to" address field completed. There may be valid business reasons to include a "ship to" address on the invoice, even though no tangible personal property was actually shipped. For instance, many common billing systems automatically populate the "ship to" field with the same information that is in the "bill to" field if there is no "ship to" address. Additionally, the seller may have its billing system set up to track electronic transfers to states where downloads are subject to tax. A sales invoice with the "ship to" address field completed should not be considered affirmative evidence showing the software was delivered via tangible personal property.

Load-and-Leave Transactions

The seller/buyer may provide any substantive evidence establishing that the software was not transferred on tangible storage media. For instance, consistent with audits of electronically transferred software, the taxpayer may provide evidence regarding its business practices and policies of only providing or receiving certain software without the transfer of storage media to the purchaser. In addition, the absence of a separate charge for storage media is evidence that no such storage media was sold to the purchaser. Although not required, if the parties executed a contemporaneous statement memorializing the facts of the "load and leave" transaction, it should be accepted as "pertinent information" that no tangible storage media was delivered to the purchaser.

A sample contemporaneous statement memorializing the facts of a load and leave transaction may be as follows: "The software program, [name of software program], was loaded on the computer of [purchaser's name] by [seller's employee or seller's agent that installed the program], and [seller's employee or seller's agent] did not transfer any tangible personal property containing the software, such as tangible media, to [purchaser's name]." This is sample language and there is no specific wording that must be included in the statement.

AUDIT PROCEDURES FOR PURCHASES 0421.05

When examining purchases of software, staff should look for evidence indicating a tangible copy of the software was furnished to the purchaser. Because sellers have a common practice regarding electronically transferred software, staff may presume purchasers of software likewise have a common practice of receiving software electronically, despite the fact purchasers utilize multiple vendors. Unless there is affirmative evidence that a copy of the software was furnished on tangible storage media in the transaction, the auditor should presume the transaction is nontaxable.

Indications that a tangible copy of the software was shipped to the purchaser may include an amount billed for transportation charges in connection with electronically transferred software, or a separately stated charge for storage media.

If the auditor still has questions as to the method of delivery, they may find it helpful to gain insight as to the seller's business practice. One way to do so would be to visit the software vendor's website to see if the vendor makes copies of its software available on disk. Another way is to determine whether the seller has been audited and if so, contact the auditor of the seller.

DONGLES 0421.06

A dongle, which is considered tangible personal property, is a security device used to prevent unauthorized reproduction of software and/or to make the software fully functional. Even in cases where the dongle is "optional," when the dongle is provided as part of the sale of software the seller is deemed to be selling a single item, as the true item sold is software subject to a physical security device without which the software will not function properly.

The inclusion of a dongle in connection with the transfer of software renders the entire transaction to be a taxable sale of tangible personal property. Whether the charge for the dongle is separately stated or not, even if sold subsequent to the transfer of the software under a separate invoice, the charges for the software (unless the software program qualifies as a custom program) and for the dongle are subject to tax. This is true even in cases where the purchaser is not contractually required to purchase the dongle, provided the purchaser must acquire the dongle to operate the software.

ANNUAL SOFTWARE LICENSE RENEWALS 0421.07

Tax generally applies to the gross receipts from the sale of annual software license agreements when the original agreement provides for the delivery of copies of the software on tangible storage media to the buyer. This is true regardless of whether or not upgrades or updates provided through the License Agreement are subsequently transferred electronically. For guidance with respect to upgrades and updates furnished pursuant to optional software maintenance contracts, see Section 0421.08.

In cases where the original software sale is subject to tax, tax applies to annual software license renewals without regard to the length of time which has elapsed or the changes resulting from the upgrades previously provided. Tax applies in the same manner whether there is a single, multi-year agreement or multiple single year agreements.

However, tax does not apply to the gross receipts from annual software license renewals when the software updates or upgrades are electronically transferred, and the original sale of the software was not taxable because the software was transferred to the licensee electronically and no copies of the software on tangible storage media were furnished with prior updates. Audit procedures, when necessary, should be performed in substantially the same manner as other sales and purchase transactions.

OPTIONAL SOFTWARE MAINTENANCE CONTRACTS 0421.08

A software maintenance contract is an agreement requiring the seller of software to provide the customer with either technical support services or software upgrades and updates, or both. A maintenance contract is optional if the purchaser may purchase the software without also purchasing the maintenance contract. Pursuant to Regulation 1502(f)(1)(C), tax applies to 50 percent of the lump sum charge for the sale of an optional software maintenance contract, when the updates and upgrades were delivered on tangible storage media. If no tangible personal property is transferred to the purchaser during the term of the maintenance contract, tax does not apply to any portion of the charge.

When an optional software maintenance contract is silent with respect to whether software on tangible storage media is to be transferred, or when the terms of an optional software maintenance contract explicitly provide that no copies of software on tangible storage media will be transferred to the purchaser, the seller is not required to report tax on any portion of the gross receipts from the sale of the optional software maintenance contract (provided that no such copies are in fact transferred).

When the parties of an optional software maintenance contract contemplate a transfer of tangible personal property, and tangible personal property is in fact transferred, tax applies to 50 percent of the lump sum charge for the sale of an optional software maintenance contract. The transaction must be reported on the sales and use tax return for the period in which the transaction occurs. If, in fact, no tangible personal property was transferred to the purchaser during the term of the maintenance contract, the seller may file a claim for refund for the tax remitted on the sale of the maintenance contract. For procedures with respect to the treatment of excess tax reimbursement and supporting a claim for refund, refer to section 0417.00.

Substantiating whether software upgrades and updates under an optional software maintenance contract were delivered electronically or by tangible media is the same as substantiating whether software was delivered electronically.

PARTIAL EXEMPTIONS 0422.00

FARM EQUIPMENT AND MACHINERY 0422.10

Revenue and Taxation Code section 6356.5 (see also Regulation 1533.1, *Farm Equipment and Machinery*), provides a partial sales and use tax exemption for the sale or purchase of farm equipment and machinery purchased for use by a qualified person to be used primarily in producing and harvesting agricultural products. See the regulation for specific definitions. For example, the following terms (and others) are found in the regulation: "farm equipment and machinery," "qualified person," "primarily," and "producing and harvesting agricultural products."

A qualified person who purchases or leases qualified property from an in-state retailer or an out-of-state retailer obligated to collect the use tax, must provide the retailer with a partial exemption certificate in order for the retailer to claim the partial exemption. If a retailer takes a partial exemption certificate timely and in good faith from a purchaser, the retailer is relieved from the liability for the sales tax subject to the partial exemption or the duty of collecting the use tax subject to the partial exemption under the regulation. A seller is presumed to have taken a partial exemption certificate in good faith in the absence of evidence to the contrary. If the purchaser does not qualify for the partial exemption or the property is not used in a qualifying manner, the purchaser is liable for the tax, with applicable interest, to the same extent as if the purchaser were a retailer making a retail sale of the property at the time the property was purchased.

In an audit of the seller, if the auditor believes the transaction does not qualify for the partial tax exemption and the seller has accepted a partial exemption certificate timely and in good faith, a CDTFA-1164, *Audit Memorandum of Possible Tax Liability*, should be issued and sent to the district of the purchaser.

For example, if the purchaser provides a partial exemption certificate to the retailer and then uses that property in a manner not qualifying for the partial exemption, or the purchaser is not a qualified person, as discussed above, the purchaser is liable for payment of the sales tax.

SOLAR POWER FACILITY 0422.15

The purchase of a solar power facility may qualify for the farm equipment and machinery partial exemption in Revenue and Taxation Code (RTC) section 6356.5. (See also Regulation 1533.1, *Farm Equipment and Machinery*). To qualify for the partial exemption, there must be:

1. A qualified person that
2. Purchases qualifying farm equipment and machinery and
3. Uses that equipment and machinery primarily in producing and harvesting agricultural products.

All three of these requirements must be met in order for the purchase to qualify for the partial exemption.

Solar Power Facility Directly Attached to Farm Equipment and Machinery

When a solar power facility is directly attached to, and primarily provides power to (i.e., operates), qualifying farm equipment and machinery, the solar power facility generally qualifies as "farm equipment and machinery." As such, the purchase of such a solar power facility generally qualifies for the partial exemption as long as the other requirements for the partial exemption are met.

Solar Power Facility Not Directly Attached to Farm Equipment and Machinery

A solar power facility may qualify as "farm equipment and machinery" when the solar power facility is not directly attached to qualifying farm equipment and machinery but is instead tied to the regional power grid and subject to a net metering agreement between the taxpayer and the electric cooperative. In such cases, the taxpayer needs to demonstrate that the solar facility is specifically purchased to provide power to (i.e., operate) qualifying farm equipment and machinery.

Factors to consider when determining if a solar power facility was specifically purchased to provide power to qualifying farm equipment and machinery include, but are not limited to:

- The basis for the design and size of the solar power facility (e.g., a study or calculation),
- The amount of power the solar power facility produces,
- The electrical power needs of the qualifying farm equipment and machinery, and
- Whether the electric cooperative required that the solar power facility be tied to the regional power grid.

When determining whether the solar power facility is primarily used in producing and harvesting agricultural products, 50 percent or more of the annual energy generated by the solar power facility needs to be consumed by the qualifying farm equipment and machinery in producing and harvesting agricultural products. This may be calculated by using the following formula:

> Total annual amount of power consumed by the qualifying farm equipment and machinery in producing and harvesting agricultural products ÷ the total annual amount of power generated by the solar power facility.

The taxpayer must provide evidence to demonstrate that the solar power facility is primarily used in producing and harvesting agricultural products. Evidence includes, but is not limited to, data from meters on the qualifying farm equipment and machinery as well as documentation of the number of pieces of qualifying farm equipment and machinery, the number of hours the qualifying farm equipment and machinery operate, and the amount of power consumed by the qualifying farm equipment and machinery per hour.

Please see Regulation 1533.1 for more information.

Construction Contracts

A solar facility may be furnished and installed by a construction contractor pursuant to a construction contract. To the extent the construction contractor is regarded as a retailer under Regulation 1521, *Construction Contractors*, the farm equipment and machinery partial exemption applies to the sale of such items to the qualified person so long as all of the requirements of RTC 6356.5 are met. On the other hand, to the extent the construction contractor is regarded as the consumer under Regulation 1521, the partial exemption does not apply to the construction contractor's purchases of materials for use in constructing the solar facility.

See AM Chapter 12, *Construction Contractors*, for additional information.

CONTRACT OPERATORS DIESEL FUEL PARTIAL EXEMPTION 0422.20

Revenue and Taxation Code section 6357.1 (See also Regulation 1533.2, *Diesel Fuel Used in Farming Activities or Food Processing*), provides a partial sales and use tax exemption for the sale, storage, use, or other consumption of diesel fuel used in farming activities or food processing. The terms "farming activities" and "food processing" are defined in Regulation 1533.2. The sale of diesel fuel to persons who conduct farming activities for farmers and ranchers on a contract basis (contract operators) qualifies for the partial sales and use tax exemption, provided the purchaser provides a timely and complete partial exemption certificate to the fuel vendor.

A contract operator is considered to be a person hired by a commercial farmer or rancher to perform farming activities in support of the raising or harvesting of any agricultural or horticultural commodity that may be legally sold or offered for sale to others. For plant products, "farming activities" include, but are not limited to, preparation of land for planting, including ripping, leveling, plowing, disking, harrowing and furrowing; seeding and planting; irrigating; spraying of herbicide or pesticides; pruning; and harvesting. For animal products, "farming activities" include, but are not limited to, herding, hauling, raising, shearing, feeding, caring for, training, and management of animals. "Farming activities" do not include activities peripheral to the actual raising and harvesting of agricultural products, such as the construction, repair or refurbishing of farming or ranching facilities or equipment.

MANUFACTURING AND RESEARCH & DEVELOPMENT EQUIPMENT 0422.25

Revenue and Taxation Code (RTC) section 6377.1 (see also Regulation 1525.4, *Manufacturing and Research & Development Equipment*) provides a partial sales and use tax exemption for the sale or purchase of: (1) qualified tangible personal property; (2) purchased for use primarily in manufacturing or research and development; (3) by a qualified person. See the regulation for specific definitions and more detailed information with respect to the three requirements to qualify.

The partial exemption applies to qualifying sales to and/or purchases by a qualified person made on or after July 1, 2014 and before July 1, 2022. To be considered a "qualified person" for the partial exemption, the business's North American Industry Classification System (NAICS) code, based on the 2012 edition published by the United States Office of Management and Budget, must fall within any code from 311100 to 339999 for manufacturers, or it must be 541711 or 541712 if engaged in research and development. The legislation limits the allowable exemption to $200 million in qualifying purchases each calendar year for each qualified person.

If a taxpayer does not know which NAICS code or industry group accurately describes their business activities, they may seek assistance on the United States Census Bureau's website where they can either search for codes, or email the Census Bureau directly with specific questions, or both.

Retailers

Retailers are required to obtain a timely partial exemption certificate from the purchaser to support a deduction for equipment purchased for use in manufacturing or research and development. The retailer must retain in its records the partial exemption certificate obtained from the purchaser; otherwise, the partial exemption will not be allowed. A seller who timely and in good faith accepts a certificate containing the necessary elements is relieved of liability for the sales tax subject to exemption or the duty to collect the use tax subject to exemption. A seller will be presumed to have taken the partial exemption certificate in good faith in the absence of evidence to the contrary.

Purchasers and Partial Exemption Certificates

Qualified persons who purchase equipment to be used in manufacturing or research and development must issue a partial exemption certificate to the retailer to allow the retailer to claim the partial exemption. The purchaser may use form CDTFA-230-M, *Partial Exemption Certificate for Manufacturing, Research and Development Equipment.*

Construction Contractors

See AM Chapter 12, *Construction Contractors*, section 1208.60, for information on qualifying purchases and/or sales by a construction contractor.

Audit Procedures

As noted above, the partial exemption has an annual cap, limiting the amount of purchases subject to the partial exemption that can be claimed in a calendar year to $200 million per qualified person. Audit staff is responsible for verifying that qualified purchasers (those described in NAICS codes 311100 to 339999, 541711, and 541712), have not exceeded the $200 million cap.

Retailers. Audit staff should verify that partial exemption certificates have been obtained for all claimed partial exemptions. General ledger sales to customers in California should be examined and reviewed on an actual basis to identify taxpayers making significant purchases. If the retailer has significant sales to an individual taxpayer that the auditor believes may cause the purchaser to exceed the $200 million annual purchase limit, a CDTFA-1164, *Audit Memorandum of Possible Tax Liability* should be sent to the district of the purchaser.

Qualified Persons. A qualified person means a person who is primarily engaged (50 percent or more of the time) in a qualified line of business either as a legal entity or as an establishment within a legal entity. See Regulation 1525.4(b)(8)(A) for a detailed definition of a qualified person.

A purchaser is not precluded from being a qualified person when there is no applicable six digit NAICS code to describe their line of business, provided their business activities are reasonably described in a qualified four digit industry group. For example, a business in the recycling industry may be regarded as a qualified person when the activities of the establishment are reasonably described in a qualified four digit industry group.

Purchasers. Audit staff should review capital asset purchases and verify tax rates paid on purchases. When incorrect tax rates are found, further review of transactions should be done on an actual basis. Staff should follow the standard audit procedures to pick up differences or have the taxpayer file a claim for refund where necessary. See Exhibit 20 for information on how to select the proper Juris Grid code in the audit upload.

Preparing Audits for Uploads

Start 21 Program – CDTFA Audit Program

1. The noncompliance code template (414N Code tab) includes three new noncompliance codes:
   - 3001 – Exemption Not Claimed
   - 3002 – Exemption Over Claimed
   - 3003 – Exemption Under Claimed
2. The Juris Grid was updated to add fund code LRF (904) to the grid. Exhibit 20 displays some possible audit scenarios that might be encountered, demonstrating the proper way to indicate the error in the linking worksheet.

Exemption Limitation

Qualified persons cannot claim more than $200 million in qualifying purchases subject to the partial exemption each calendar year. Persons may make purchases and issue partial exemption certificates with the intention of qualifying for the partial exemption in the one year period following the date of purchase. If a purchaser issues a partial exemption certificate to the seller and later discovers they exceeded the annual cap or the purchase does not qualify for the partial exemption, the purchaser is liable for the difference to equal the full payment of sales tax plus applicable interest as if the purchaser were a retailer making the sale at the date of purchase.

To report the tax difference, the taxpayer must report the amount of their over claimed purchases on their sales and use tax return for the period the purchases were made. The taxpayer reports the amount of their over claimed purchases as a negative entry on the return line, *Sales Made Subject to the Manufacturing and Research and Development Equipment Exemption*. If the taxpayer is reporting other transactions on this line that are subject to the partial sales and use tax exemption (for example, qualifying sales to another qualified person), then the taxpayer should net the over claimed purchase amount from those transactions and report the total net amount.

If the taxpayer does not hold a seller's permit, they have to register for a Consumer Use Tax Account to report and pay the tax difference on a Consumer Use Tax Return. These payments will create a return edit and the allocation to the proper accounts will have to be processed by the Return Analysis Unit and the Local Revenue Branch.

LEASES OF TELEPRODUCTION OR POSTPRODUCTION SERVICE EQUIPMENT 0422.30

Revenue and Taxation Code section 6378 (see also Regulation 1532, *Teleproduction or Other Postproduction Service Equipment*), provides a partial sales and use tax exemption for the sale or purchase for use in this state of qualified teleproduction or other postproduction service machinery and equipment purchased for use by a qualified person to be used primarily in teleproduction or other postproduction activities. Refer to the regulation for specific definitions.

Retailers who timely obtain a partial exemption certificate from the purchaser stating the property will be used in a qualifying manner should not charge or collect the state portion of the sales or use tax at the time of purchase. The partial exemption does not apply to any local, city, county or district taxes. When a retailer accepts a partial exemption certificate timely and in good faith and it is later determined the purchase does not meet the criteria for the exemption, the state portion of the sales or use tax, plus applicable interest, is due by the purchaser.

Leases in General

Leases which are classified as "continuing sales" and "continuing purchases" of tangible personal property in accordance with Regulation 1660, *Leases of Tangible Personal Property – in General*, may qualify for the partial exemption subject to the limitations in Regulation 1532, subdivision (i)(1).

Leases of otherwise qualifying machinery and equipment to a qualified person in substantially the same form as acquired by the lessor, as to which the lessor has paid sales tax reimbursement or use tax measured by the purchase price do not qualify as "continuing sales" or "continuing purchases" and, as such, do not generally qualify for the partial exemption.

Further, Regulation 1660, subdivision (c)(3) PROPERTY PURCHASED TAX PAID, provides: "In the case of property ultimately leased in substantially the same form as acquired, payment of tax or tax reimbursement measured by the purchase price at the time the property is acquired constituted an irrevocable election not to pay tax measured by rental receipts. The lessor may not change his or her election by reporting tax on rental receipts and claiming a tax-paid-purchase-resold deduction. Thus, a lessor who made such an election to pay tax on cost cannot subsequently change that election and pay tax on rental receipts for purposes of leasing the property subject to the partial exemption."

Leases of Qualified Machinery and Equipment in Substantially the Same Form

When property is leased in substantially the same form as acquired by the lessor, the applicable transaction that must be examined is the sale to the leasing company. Leasing companies are generally *not* qualified persons, thus, the sale to the lessor generally does not qualify for the partial exemption. However, auditors may encounter situations where a qualified person is a lessor of equipment. Regulation 1532 allows a qualified person to purchase qualified equipment under a partial exemption certificate and later lease the equipment to another person. The *purchase* of the qualified equipment by a qualified person is eligible for the partial exemption under any of the following circumstances:

- The property is used primarily (50 percent or more of the time in the 12 month period following the date of purchase) by the qualified purchaser in a qualifying manner prior to being leased to a non-qualified person.
- The property is leased to a qualified person who uses the property primarily in a qualified activity during the 12 month test period.
- Any combination of the above where the qualified use exceeds 50% or more in the 12 month period following the date of purchase.

In cases where a leasing company issues a partial exemption certificate to a retailer for the purchase of qualified equipment to be leased in the same form as acquired, but subsequently fails to meet the requirements of a qualified person or uses the property in a manner that does not qualify for the partial exemption, the leasing company is considered to have made an irrevocable election to pay tax on the purchase price of the equipment acquired for leasing, irrespective of the fact that the full tax rate was not remitted. In accordance with Regulation 1532, subdivision (e)(5), the leasing company is liable for payment of the state portion of the sales tax excluded by the partial exemption based on the sales price of the property to the leasing company.

However, tax is due based upon lease receipts if the purchaser/lessor issued a resale certificate (or failed to make a timely election to remit the partial tax due when purchasing from an out-of-state seller who does not hold a permit) on their purchase of the equipment.

AUDIT OF FRANCHISORS OR LARGE RETAILERS 0423.00

THIRD-PARTY DATA REQUESTS TO FRANCHISORS AND LARGE RETAILERS 0423.10

The Data Analysis Section (DAS) coordinates, solicits and maintains a database of third-party data for use in audit selection, to create leads for audit and compliance programs, and to provide purchase/sales information to auditors on accounts being audited. Third-party data is solicited from various resources such as auction houses, big box retailers, and franchisors.

Third-party data resources may be identified during audit selection and while auditing a franchisee, franchisor or large retailer. To enhance the third-party database and streamline requests, DAS will coordinate requests for franchisor or large retailer data with the district office in which the franchisor/large retailer is located or with the office auditing a franchisor/large retailer. District staff will request the third-party data (i.e., either sales reported to the franchisor by their California franchisee, or all sales made by the large retailer to their resale customers) using the CDTFA-116 forms as described below.

The following two forms are available on myCDTFA to request third-party data from franchisors or large retailers. District staff should use these forms when requesting third-party data directly from franchisors or large retailers that are identified by the Business Tax and Fee Department (BTFD) or the DAS.

- CDTFA-116-A, *Franchisor / Vendor Sales Transaction Data-1st Request*, and
- CDTFA-116-B, *Franchisor / Vendor Sales Transaction Data-2nd Request*,

PROCEDURE 0423.15

When staff begins an audit suited for a third-party data request, the CDTFA-116-A must be used for the request. This form allows users to fill in or choose relevant information and may be addressed to either franchisors or large retailers. The CDTFA-116-A is signed by the District Principal Auditor (DPA) and instructs the franchisor/large retailer to send the data directly to DAS. DAS is copied on the CDTFA-116-A. Third-party data should be requested for the same period(s) as the franchisor or large retailer is being audited.

Once the initial request for the third-party data to the franchisor or large retailer is made using the CDTFA-116-A, DAS will monitor the request. If necessary, the DPA will send a follow-up second request using the CDTFA-116-B. DAS maintains a central list of all data requested through the use of these forms. If a franchisor/large retailer does not comply with the request to supply records, the DPA of the district conducting the audit may pursue a subpoena for records as outlined in Exhibit 4.

Upon receipt of the third-party data from the franchisor or large retailer, DAS will notify the district office and process, cleanse, data match, and validate the data to CDTFA IRIS registration for seller's permit identification and verification. Any leads (i.e., noncompliance leads and under-reported leads) that result from processing this third-party data will be sent to the appropriate district.

In order to avoid sending franchisors or large retailers multiple requests for the same data, staff is instructed to contact DAS for third-party data availability when auditing a franchisee and certain large retail accounts. For franchisor accounts not already available in DAS, staff should use their judgment and discuss with their supervisors if they believe a third-party data request is appropriate. All questions regarding third-party data should be emailed to *SUTD-Data Request Mailbox*.

AUDIT OF THE LUMBER PRODUCTS ASSESSMENT 0424.00

GENERAL 0424.05

The Board of Equalization (CDTFA) is responsible for administering a one percent (1%) assessment imposed on the purchase of lumber products and engineered wood products based on the selling price. Under the law (Public Resources Code §§ 4629 - 4629.13), retailers selling lumber products or engineered wood products are required to charge and collect the 1% assessment on sales of these products to consumers. In addition to retailers, purchasers, including construction contractors, who purchase lumber products or engineered wood products for use in California without paying the 1% assessment to a registered California retailer are required to report and pay the assessment directly to the CDTFA.

The law requires electronic filing of the lumber products assessment. There is no paper return available to taxpayers to use in reporting and paying. Taxpayers identified as lumber retailers (ACC 39) are prompted to complete a lumber schedule to report and pay their lumber products assessment when filing their sales and use tax return. Taxpayers that are ineligible or exempt from online filing of their sales and use tax returns are required to electronically file a "lumber only" return.

Low-Volume Retailers

A "low-volume retailer" is a retailer whose sales of qualified lumber products and engineered wood products are less than $25,000 during the previous calendar year. For purposes of meeting the threshold, retailers that have more than one location must include sales of qualified lumber products and engineered wood products from all locations when determining if the threshold is met.

Effective January 1, 2015, low-volume retailers are not required to register and collect the assessment from their customers for the subsequent calendar year. However, they may choose to do so voluntarily. If they do not voluntarily collect the assessment, these retailers are still required to track their annual sales to determine whether or not they will be required to collect the assessment the following year. Low-volume retailers are also required to notify their customers (the purchaser) that they must pay the 1% assessment directly to the CDTFA and to notify the CDTFA to remove the lumber schedule from their accounts.

Additional Information:

- Penalty and interest apply to outstanding lumber products assessment liabilities as established pursuant to Revenue and Taxation Code (RTC) section 6591.5.
- The lumber products assessment law does not contain a provision to allow a retailer to claim a bad debt deduction for the lumber products assessment.
- The tax-paid purchases resold deduction does not apply as the lumber products assessment is imposed on the consumer.
- Taxpayers may file a claim for refund directly with the CDTFA for overpayments of the 1% assessment.

LUMBER PRODUCTS AND ENGINEERED WOOD PRODUCTS 0424.10

The State Board of Forestry and Fire Protection (BOF) is responsible for identifying specific products subject to the assessment. In general, lumber products and engineered wood products subject to the 1% assessment are building products usually used in construction in which wood is at least 10% of total content – for example, all dimensions and grades of lumber, roofing (shakes and wooden shingles), siding, lath, plywood, particle board, fiberboard, oriented strand board, I-joists, laminated veneer lumber, veneer-based sheeting material, and inorganic-bonded and wood thermoplastic composites, including lumber and decking. Based on guidance provided by the BOF the lumber products assessment does *not* apply to products where labor has added 'significant value' to them, such as:

- Furniture,
- Doors,
- Windows, and
- Decorative products such as wainscoting, paneling, molding, or baseboards that have added profiling, patterns, chamfering or other craftsmanship.

However, the addition of any value to a lumber product does not automatically result in a product not being subject to the assessment. Many lumber products undergo additional processing before being used, but are still subject to the assessment, for example lumber that is graded and planed. In addition, engineered wood products, which are subject to the assessment, have been, by definition, processed or manufactured from raw materials. Thus, it is important to review the Lumber Products Assessment industry guide on the CDTFA website when trying to determine if a product is subject to the lumber products assessment. The *Lumber Products Assessment* industry guide provides examples of products subject to and excluded from the 1% assessment.

Staff may receive questions from taxpayers about whether a specific item is subject to the 1% assessment. If the product is not listed on the CDTFA's webpage and further direction is needed, staff should forward the inquiry to the Tax Policy Division, Audit and Information Section (AIS). When forwarding product inquiries to AIS, if possible, obtain a link to the website describing the product, or other descriptive information about the product in question. When appropriate, AIS will forward product inquiries to BOF for their determination. Determinations from BOF regarding product inquiries will be added to the *Lumber Products Assessment* page as necessary.

AUDITS 0424.15

Auditors are responsible for verifying that affected taxpayers are in compliance with the lumber products assessment program (see AM section 0424.25, Retailers) and that the correct lumber products assessment has been reported and paid.

VERIFICATION OF ACCOUNT STATUS

Auditors must verify that the account characteristic code (Acct Char field on the TAR AI screen) is correctly coded as a lumber account with 39. Beginning January 1, 2015, retailers selling less than $25,000 in lumber products during the previous calendar year (low volume retailers) are not required to register or collect the assessment but may do so voluntarily. (See AM section 0424.05, for information on low-volume retailers.)

If the taxpayer is a lumber product retailer or purchaser/consumer of lumber products and the account has not been coded with ACC 39, auditors must contact appropriate compliance staff to:

- Add ACC 39 to the account.
- Manually add the Lumber Products Assessment (LUM) FO's for the appropriate prior periods.

If the taxpayer's account is coded ACC 39 and the taxpayer is not a lumber product retailer or purchaser/consumer, auditors must contact appropriate compliance staff to:

- Remove ACC 39 from the account
- Clear any empty (unfilled) LUM FO's

AUDIT REPORTS

Report of Field Audit

The CDTFA-414-A, *Report of Field Audit* for lumber retailers or purchasers (ACC 39) must show liabilities established for sales and use tax and the lumber products assessment separately. The General Comments embedded Word document has a drop-down for lumber products assessment (LPA) comments. The Audit Summary Workbook (ASW), *Tax Returns* Worksheet, provides for comments regarding the lumber fee. The CDTFA-414-E for accounts with the ACC 39 includes the combined reported measure for both sales and use tax and the lumber assessment.

Transcript of Returns

Auditors receive an additional file path to download the lumber transcripts of returns. Auditors should verify that all periods in which the taxpayer sold or purchased lumber have reported amounts (including zeros) for lumber transactions. Auditors should be alert to situations in which prior period LUM FO's must be created or deleted.

Audit Payment Form

The CDTFA-1, *Audit Payment Information Form* (printed with the Audit Report) for accounts with ACC 39 shows separate balances for the sales and use tax liability and the lumber products assessment liability. The payment form will allow taxpayers to designate payment amounts to the sales and use tax liability and the lumber products assessment liability.

AUDIT PROCEDURES

Accounts that sell or purchase lumber products (coded with ACC 39) require additional verification and testing procedures for the lumber assessment that should include the following:

Verification of Products Subject to the 1% Assessment

Auditors should verify that the taxpayer is correctly charging the 1% assessment on products categorized as lumber or engineered wood products. Auditors should refer to the *Lumber Products Assessment* industry guide on the CDTFA website and the BOF's *Lumber Products Assessment Regulation* as guidance for products subject to the assessment. Auditors should review this information for any updates and revisions prior to beginning the audit.

If necessary, auditors should advise the taxpayer to begin collecting the 1% assessment on specific products and document in the *Audit Report* that the taxpayer was advised the specific product is subject to the 1% assessment.

Reconciliation of Sales

Taxpayers report their net transactions subject to the lumber products assessment on the lumber schedule of the sales and use tax return; the lumber schedule does not include lines for deductions. Auditors should reconcile recorded sales (and purchases, if applicable) to the net reported transactions subject to the 1% assessment. Unexplained differences should be assessed in the same manner as sales and use tax reconciliation errors on the lumber products assessment schedule.

Reimbursement Costs

Auditors must verify that the taxpayer's total claimed reimbursement for start-up costs is correctly offset against the taxpayer's reported lumber assessment revenue. See AM section 0424.25 for an explanation of eligible retailers and allowable start-up costs. Allowable start-up reimbursement costs not claimed as an offset on the taxpayer's returns may be credited against any additional lumber products assessment established in the audit or established as a credit offset in the audit, provided the taxpayer has previously reported sufficient lumber products assessment revenue to offset the reimbursement.

Test of Lumber Sales

In general, sales that are not subject to sales or use tax (such as resales and interstate or foreign commerce sales) are not subject to the 1% assessment. If a preliminary review of sales suggests that additional testing of lumber product sales is necessary, auditors should also test (either sample or census) lumber product sales to verify that the retailer correctly charged and collected the 1% assessment on sales of lumber or engineered wood products to purchasers for use in California.

Auditors should follow standard policy and procedures for testing and error projection as stated in Audit Manual Chapter 4, *General Audit Procedures*, and Chapter 13, *Statistical Sampling*.

Verification of Construction Contractors

In general, sales to, or purchases by, construction contractors of lumber products that are consumed in the performance of a construction contract in California are subject to the 1% assessment. If a contractor purchases lumber products ex-tax from outside of California or under a resale certificate from California vendors that do not charge the 1% assessment, the construction contractor is responsible for the 1% assessment as well as any use tax on the lumber or engineered wood products consumed in the performance of the construction contract in California (See AM section 1208.55).

Auditors should perform a cost accountability test for lumber and engineered wood products to verify that the 1% assessment was properly paid or reported (see Audit Manual Chapter 12, section 1205.10).

Lumber Schedules

Results of lumber tests should be scheduled separately in the Excel workbooks, using new spreadsheets for:

- Lumber Products Assessment (LPA), and
- Lumber Products Reimbursement Offset (LMRB)

General and Verification Comments

The General Comments embedded Word document has a drop-down for lumber products assessment (LPA) to enter relevant general comments (for example, the taxpayer is a retailer and/or purchaser of lumber or engineered wood products). The Audit Summary Workbook (ASW), *Tax Returns* Worksheet, provides for comments regarding the lumber fee.

In the Audit Workbook, auditors will use the *Misc Title* drop-down for lumber products assessment verification comments. Auditors should enter verification comments to explain the tests conducted and findings of the lumber portion of the audit investigation.

PREPARING AUDITS FOR UPLOADS

Start 21 Program – CDTFA Audit Program

The noncompliance code template (414N Code tab) includes four noncompliance codes for lumber:

- 2901 – Errors in Compiling Return
- 2902 – Difference Between Tax Accrued/Paid
- 2903 – Exemption Netted in Error
- 2904 – Exemption Not Claimed

The Juris Grid has two jurisdictions for lumber:

- Lumber Products Assessment (LPA) and
- Lumber Products Reimbursement Offset (LMRB).

The linking worksheets will include additional columns to coincide with the additional lumber jurisdictions.

Audits with Separate Underpayment (Debit) and Overpayment (Credit) Established for Sales/Use Tax and Lumber

Audits that establish an underpayment for one component (sales/use tax or lumber assessment) and an overpayment for the other component require separate notices issued to the taxpayer (i.e., a *Notice of Determination* issued for the understatement and a *Notice of Refund* issued for the overpayment). In this situation, a separate *Field Billing Order* (FBO) must be created for the lumber product assessment (either overpayment or underpayment) in order to issue the separate notice.

For combination debit/credit audits, do the following:

- Complete the Audit Report for both sales/use tax and the lumber products assessment including entire Start 21 (414A-p3), schedules, comments (Audit and FBO; see note below), files, and forms, but do not create the juris grids and linking worksheets.
- Obtain a separate case ID for the FBO for the lumber component.
- Make a copy of the entire audit case folder for FBO case ID.
- On the copy, change audit case ID to new FBO case ID.

NOTE: General Comments for the audit should state a separate FBO for the lumber assessment was prepared and reference the FBO case ID. General Comments for the FBO only need "*See original audit*" and the reference to the audit case ID.

In the copied FBO folder for the lumber products assessment:

- Delete the subfolders that are in the original audit (except CDTFA-122, CDTFA-101 and any folders relevant to the lumber products assessment).
- Change the case ID on all files to the FBO case ID, including the Start 21 file, the Excel workbook, CDTFA-122, CDTFA-101, etc.
- In Start 21, on Start tab, change the following:
    - Case ID for FBO
    - Audit period for lumber (if different)
    - Audit hours
    - Select FBO as audit type
- In Start 21, on 414-A-p3:
    - Select letter type for FBO
    - Complete *Did taxpayer concur?*
    - Complete *A copy of this report was…..*
- In the Audit Workbook for the FBO
    - Delete the sales and use tax schedules
    - Create a juris grid with linking worksheets
    - Create the upload files
    - Submit the FBO
- In the Audit Workbook for the audit
    - Create the juris grid with linking worksheets (excluding the lumber errors)
    - Create upload files
    - Submit the audit

Audit Control will upload both the audit case and the FBO case.

AUDIT (AUD) IRIS SCREENS

<u>Audit FO (AUD FO) – View Audit Return (REV RA)</u> – Accounts coded with ACC 39 have only one audit case ID and one AUD FO. Sales/use tax and lumber liabilities established in an audit show as linked differences (DIF DA screen) under the single AUD FO. Staff may view the details of the sales/use tax and lumber differences for the AUDIT FO in the REV RA screen.

<u>Audit Maintain/Inquire Noncompliance Category (AUD IN)</u> – IRIS has four noncompliance codes for lumber under category code 29 as follows:

- 01 – Errors in Compiling Returns
- 02 – Differences Between Tax Accrued/Paid
- 03 – Exemption Netted in Error
- 04 – Exemption Not Claimed

Audit Maintain/Browse Offset Type (AUD OS) – An offset type for the Lumber Products Assessment reimbursement (LMRB) can be viewed under the AUD OS screen.

Audit Interest and Penalty Calculation (AUD PI) – Interest and penalty is calculated separately for sales/use tax and lumber liabilities established in an audit. The AUD PI screen allows users to toggle back and forth between SUT and LUM interest and penalty calculations with the F6 key.

Audit Adjust Calculation Result (AUD CA) – The AUD CA screen allows users to toggle back and forth between sales/use tax and lumber to calculate the interest and penalty separately for sales/use tax and lumber with the F6 key.

Browse Audits for Account (AUD X1) – Accounts with ACC 39 will be identified with an 'L' at the end of the audit case ID on the AUD X1 screen.

Audit Maintain/Inquire Summary of Differences (AUD SD) – Audit differences for the lumber products assessment can be viewed in the AUD SD screen using the jurisdiction code: LPA.

Audit Maintain/Inquire Offset Schedule (AUD OS) – Offsets allowed in the audit for reimbursement of start-up costs can be viewed in the AUD OS screen using the jurisdiction code: LMRB.

APPEALS AND RETURNS 0424.20

Protests of Products Subject to the Assessment

The BOF is responsible for determining which products are subject to the 1% assessment. The CDTFA may petition the Executive Officer of BOF for a review of whether a product is subject to the 1% assessment by submitting a petition that includes the specific basis on which the lumber product may or may not meet the criteria established pursuant to Public Resources Code §4629.3.

The Executive Officer of BOF shall complete the review of the petition within 30 days of its receipt (or the receipt of any additional information that may have been requested). The Executive Officer of BOF determines whether or not the product(s) in the petition is subject to the lumber products assessment. In general, after the Executive Officer of BOF has made the determination, there is no further appeal. However, a taxpayer may directly petition the BOF to initiate rulemaking to address their issue, or to ask BOF to modify the regulation during its annual review.

District Responsibility

If a taxpayer makes a protest directly to the district (including through a sales and use tax audit) that a specific product(s) is not subject to the 1% assessment, the district is responsible for reviewing the taxpayer's protest and verifying that:

- The protested products(s) are not specifically included in the BOF's *Lumber Products Assessment Regulation.*
- The protested product(s) were not reviewed by the BOF based on a previous inquiry to BOF for additional guidance and/or added to the CDTFA's Lumber Page (see AM section 0424.10).
- The protest includes the basis upon which the protest is made.

After verifying the above, the district will then submit the protest to AIS. AIS is responsible for forwarding petitions to BOF for their review. AIS will inform the district of BOF's determination.

Protest Other than Products Subject to the Assessment

Protests of the lumber product assessment other than whether a product is subject to the assessment will be handled in the same manner as protests and appeals of other Sales and Use Tax and Special Taxes liabilities (See AM Chapter 14, *Appeals Procedures)*.

- The Petitions Section will acknowledge petitions for redetermination and administrative protests for accounts with lumber in the same manner as accounts without lumber.
- The Appeals IRS screens (APL) include appeals for lumber accounts. The financial data screens show the lumber amounts separate from the sales and use tax amounts.
- The APL MH financial data screen includes additional lines for lumber adjustments to a liability.

Refunds

Refunds for sales and use tax and the lumber assessment are processed separately and taxpayers receive separate refund checks for each. A refund of sales/use tax (or lumber) can be applied as an offset to the lumber liability (or sales /use tax) for the same account.

RETAILERS 0424.25

Retailers of lumber products and engineered wood products are required to:

- Charge and collect the 1% assessment on sales of lumber products or engineered wood products for use in this state.
- Separately state the amount of the lumber products assessment on the sales receipt given to the customer.
- Report and pay the lumber products assessment to the CDTFA on their sales and use tax return.
- Notify the CDTFA if their sales and use tax return does not include the lumber schedule.

For information on “low-volume retailers” see AM section 0424.05.

Reimbursement of Start-Up Costs

For 2013, retailers of lumber products or engineered wood products may retain $250 per business location as start-up costs associated with the collection of the 1% assessment. Beginning January 1, 2014, these retailers may retain an additional $485 per business location as start-up costs.

A “business location” is defined as a location registered under the retailer’s seller’s permit as of January 1, 2013, where sales of products subject to the assessment are made. Out-of-State retailers engaged in business in California with no California locations are considered to have one registered location (for example, SC accounts). Retailers with locations both inside and outside of California may claim an offset for their registered locations, which includes sub locations listed in IRIS, where lumber or engineered wood products subject to the assessment are sold.

RETAILERS (CONT.) 0424.25

Retailers that were not in the business of selling lumber products or engineered wood products prior to the imposition of the lumber products assessment on January 1, 2013, as well as retailers that acquire their seller's permit on or after January 1, 2013, are not eligible to reimburse themselves for any start-up costs.

For 2013, eligible retailers may offset their reported lumber products assessment for the allowable start-up costs ($250 per business location) beginning with their first return upon which the lumber products assessment is reported and continuing on consecutive returns until the entire reimbursement amount is retained. Beginning with returns due on or after January 1, 2014, eligible retailers may offset their reported lumber products assessment for the additional allowable start-up costs ($485 per business location).

PURCHASERS 0424.30

Purchasers, including construction contractors (see AM section 1208.55), who purchase lumber or engineered wood products for use in California and who do not pay the 1% assessment to a registered California retailer are required to report and pay the assessment directly to the CDTFA. The lumber products assessment cannot be reported and paid on the California State income tax return (Franchise Tax Board).

Purchasers may not claim reimbursement for start-ups costs.

AUDIT OF THE LEAD-ACID BATTERY FEES 0425.00

GENERAL 0425.05

Effective April 1, 2017, two new lead-acid battery fees were imposed on consumers and manufacturers of lead-acid batteries. A $1.00 California battery fee was imposed on the consumer, and a $1.00 manufacturer battery fee was imposed on the manufacturer of the lead-acid battery. Both fees generally apply to batteries, typically designed for use in a vehicle, watercraft, aircraft or equipment that are purchased or sold in California.

The California Department of Tax and Fee Administration (CDTFA) is responsible for the administration of the lead-acid battery fees in cooperation with the Department of Toxic Substances Control (DTSC). Additional information regarding these fees is available in the Lead-Acid Battery Fees Guide. The fee rates can be found on CDTFA's website at https://www.cdtfa.ca.gov/taxes-and-fees/tax-rates-stfd.htm.

BATTERIES SUBJECT TO THE LEAD-ACID BATTERY FEES 0425.10

The lead-acid battery fees generally apply to sales and purchases of batteries designed for use in a vehicle, watercraft, aircraft or equipment. The batteries must be primarily composed of both lead and sulfuric acid (liquid, solid, or gel), weigh over five kilograms (about 11 pounds), and have a capacity of six or more volts.

Different registration, filing, and reporting requirements apply to retailers than those that apply to manufacturers or importers. Section 0425.20 discusses the California battery fee and specifies the retailer requirements; Section 0425.30 discusses the manufacturer battery fee and specifies the manufacturer or importer requirements.

CALIFORNIA BATTERY FEE—BR ACCOUNTS 0425.20

The Business Tax and Fee Division (BTFD) is responsible for the administration of California battery fee accounts for retailers of replacement lead-acid batteries. A new Taxable Activity Type (TAT), BR, was created for retailers of replacement lead-acid batteries. The BR account requires separate registration and filing from all other TATs (SR, SC, RB, etc.). All retailers of lead-acid batteries are required to register for a BR account in addition to their seller's permit.

RETAILER

Dealers of replacement lead-acid batteries are required to charge and collect the California battery fee from consumers at the time of the sale. A dealer is defined as a person who sells replacement lead-acid batteries at retail in this state. This includes manufacturers who make retail sales directly to a person in California through any means. For purposes of this section, a replacement lead-acid battery dealer is referred to as a retailer.

REPLACEMENT LEAD-ACID BATTERY

A replacement lead-acid battery is a new lead-acid battery sold at retail in California as a replacement for the lead-acid battery that originally came with the vehicle, watercraft, aircraft, or other equipment in which the new lead-acid battery is intended or designed to be used. A replacement lead-acid battery does not include spent, discarded, refurbished, reconditioned, rebuilt, or reused lead-acid batteries.

LEAD-ACID BATTERIES SUBJECT TO THE CALIFORNIA BATTERY FEE

The California battery fee applies to sales of new replacement lead-acid batteries primarily composed of both lead and sulfuric acid, whether sulfuric acid is in liquid, solid, or gel form, weighing over five kilograms (about 11 pounds) with a capacity of six or more volts that is used for any of the following purposes:

- As a starting battery that is designed to deliver a high burst of energy to an internal combustion engine until it starts.
- As a motive power battery that is designed to provide the source of power for propulsion or operation of a vehicle, including a watercraft.
- As a source of auxiliary power to support the electrical systems in a vehicle, as defined in section 670 of the Vehicle Code, including a vehicle as defined in section 36000 of the Vehicle Code, or an aircraft.

THE CALIFORNIA BATTERY FEE DOES NOT APPLY TO:

- A sale for purposes of resale in the regular course of business.
- A sale of a replacement lead-acid battery where the California battery fee has already been imposed and paid.
- A replacement lead-acid battery temporarily stored or used in California for the sole purpose of preparing it for use only outside the state and that it is subsequently transported and used solely outside of the state.
- A battery sold for incorporation into new equipment for subsequent resale.
- A replacement lead-acid battery replaced under a vehicle or battery warranty[1] or a vehicle service contract, as defined under section 12800 of the Insurance Code.
- A battery intended for use with, or contained within, a medical device as defined in the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 321(h)). For specific medical devices, view the FDA'S searchable database.
- Any lead-acid battery used as a stationary storage or standby battery that is designed to be used in systems where the battery acts as either:
  - Electrical storage for electricity generation equipment,
  - A source of emergency power, or
  - Otherwise serves as a backup in case of failure or interruption in the flow of power from the primary source.

[1] A battery replaced under warrnaty, with no additional cost to the purchaser.

AUDITS OF BR ACCOUNTS 0425.25

The Audit Examination Branch (AEB) conducts audits of BR accounts in the same manner as other special tax and fee programs. Audit staff is responsible for verifying that retailers of replacement lead-acid batteries are properly registered and in compliance with reporting requirements.

The Lead-Acid Battery Fees Program was implemented April 1, 2017. If a BR account is audited in conjunction with another program, two case ID numbers will be used. A separate audit report is prepared for BR accounts using the Audit Forms (Start 21) and the Audit Workbook.

Audit staff may obtain the transcript of California battery fee returns filed for BR accounts in the same manner as other special tax and fee accounts.

AUDIT PROCEDURES

Audit staff will conduct BR audits similar to other special tax audits; i.e., reconcile recorded to reported sales, verify exclusions such as sales for resale, and lead-acid batteries for use outside California, etc., and include the following procedures:

Verification of Batteries Subject to the Fees

Audit staff should verify that the retailer is correctly charging the California battery fee on sales of replacement lead-acid batteries. See sections 0425.20 and 0425.30 and the *Lead-Acid Battery Fees Guide*, for information on batteries subject to the lead-acid battery fees as well as applicable exclusions from the fees.

Reimbursement Costs

Retailers may retain 1.5% of the California battery fee collected as reimbursement for their costs of collecting the fee. The reimbursement amount is automatically calculated and deducted on the BR return. Audit staff should verify that the retailer correctly reported their replacement lead-acid battery sales prior to deducting the reimbursement costs.

AUDIT UPLOADS

BR audit report uploads follow the existing procedures for special tax and fee accounts. Additional noncompliance codes for “Lead-Acid Batteries Overstated” and “Lead-Acid Batteries Understated” specific to the California battery fee are available.

SALES AND USE TAX (SUT) AND OTHER SPECIAL TAX AND FEE (STF) AUDITS OF RETAILERS SELLING BATTERIES

When an SUT or other STF audit or field billing order is prepared, audit staff should indicate whether or not the business sells lead-acid batteries in the system on the Audit Springboard, Audit Tab, under the Attributes subtab. If the audit investigation results in a No Opinion Warranted (NOW) report, audit staff should indicate whether or not the business sells lead-acid batteries in Section B of the CDTFA-1010. A copy of the CDTFA-1010 should then be emailed to BTFD-PCD Ops Memo 1096. Audit staff from SUT and AEB will prepare separate audit reports for each account.

PETITIONS AND CLAIMS FOR REFUND

In general, petitions and claims for refund for BR accounts follow the normal appeals procedures currently in place for special tax and fee accounts governed by the Fee Collection Procedures Law (FCPL).

The Appeals and Data Analysis Branch (ADAB) processes all petitions and claims received unless based upon the grounds that a battery is, or is not, a lead-acid battery. The ADAB shall forward any petition or refund claim based on those grounds to the Department of Toxic Substances Control (DTSC) for review.

CONSUMERS PAYING THE CALIFORNIA BATTERY FEE DIRECTLY TO CDTFA

Consumers buying replacement lead-acid batteries for use in this state, who did not pay the fee to a registered California retailer, can pay the California battery fee directly to the CDTFA by check. An arbitrary account will be set up for the purchaser's payment of the California battery fee. The online registration system does not allow purchasers to report and pay the California battery fee for the one-time purchase of a replacement lead-acid battery. Purchasers cannot report and pay the California battery fee on their state income tax return to the Franchise Tax Board.

MANUFACTURER BATTERY FEE—BC ACCOUNTS 0425.30

The BTFD is responsible for the administration of manufacturer battery fee accounts for manufacturers of new lead-acid batteries. A new Taxable Activity Type (TAT), BC, was created for manufacturers of lead-acid batteries. The BC account requires separate registration and filing from all other TATs (SR, SC, RB, etc.). All manufacturers of lead-acid batteries are required to register for a BC account even if they currently hold a seller's permit or certificate of registration – use tax.

Manufacturers who make retail sales of lead-acid batteries directly to consumers in California, such as a sale through a sales outlet, catalog, Internet website, or any other similar means, must also register as a retailer for a BR account, collect, and pay the $1.00 California battery fee to the CDTFA, in addition to reporting and paying the manufacturer battery fee. See section 0425.20 and the *Lead-Acid Battery Fees Guide* for more information.

MANUFACTURER

A lead-acid battery manufacturer is generally the person who manufactures the lead-acid battery and who sells, offers for sale, or distributes the lead-acid battery in California. If the person who manufactured the battery is not subject to the jurisdiction of this state, the person who imports the lead-acid battery into California for sale or distribution is regarded as the manufacturer for purposes of the fee and is responsible for the manufacturer battery fee. For purposes of this section, an "importer" refers to any person who imports the lead-acid battery into California for sale or distribution in this state.

LEAD-ACID BATTERIES SUBJECT TO THE MANUFACTURER BATTERY FEE

The manufacturer battery fee applies to the sale, in California, of all lead-acid batteries primarily composed of both lead and sulfuric acid (liquid, solid, or gel) weighing over five kilograms (about 11 pounds) with a capacity of six or more volts that is used or designed to be used for any of the following purposes:

- As a starting battery that is designed to deliver a high burst of energy to an internal combustion engine until it starts.
- As a motive power battery that is designed to provide the source of power for propulsion or operation of a vehicle, including a watercraft.
- As a stationary storage or standby battery that is designed to be used in systems where the battery acts as either electrical storage for electricity generation equipment or a source of emergency power, or otherwise serves backup in case of failure or interruption in the flow of power from the primary source.
- As a source of auxiliary power to support the electrical systems in a vehicle, as defined in section 670 of the Vehicle Code, including a vehicle as defined in section 36000 of the Vehicle Code, or an aircraft.

THE MANUFACTURER BATTERY FEE DOES NOT APPLY TO:

- A lead-acid battery for which the manufacturer battery fee has previously been paid.
- A lead-acid battery temporarily stored or used in California for the sole purpose of preparing it for use only outside the state and it is subsequently transported and used solely outside of the state.
- A battery for incorporation into new equipment for subsequent resale.
- A lead-acid battery replaced under a vehicle or battery warranty[1] or a vehicle service contract, as defined under section 12800 of the Insurance Code.
- A battery intended for use with, or contained within, a medical device as defined in the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 321(h)).

AUDITS OF BC ACCOUNTS

The Audit Examination Branch (AEB) will follow the same procedures for audits of BC accounts as audits of BR accounts outlined in section 0425.25 with the exception of *Reimbursement Costs* which do not apply to the manufacturer battery fee.

PETITIONS AND CLAIMS FOR REFUND

In general, petitions and claims for refund for BC accounts follow the normal procedures currently in place for special tax and fee accounts governed by the FCPL. The ADAB will process all petition and refund claims received from manufacturers and importers unless it is based upon the grounds that a battery is not a lead-acid battery. The ADAB will forward any petition or refund claim based on those grounds to the DTSC for review.

1 [2] A battery replaced under warranty, with no additional costs to the purchaser.

AUDIT OF THE PREPAID MOBILE TELEPHONY SERVICES SURCHARGE 0426.00

GENERAL 0426.05

Effective January 1, 2016, a Prepaid Mobile Telephony Services (prepaid MTS) Surcharge[1] was imposed on consumers of prepaid wireless services and products purchased in a retail transaction in California. Sellers of prepaid wireless services and products are required to charge and collect the surcharge at the time of the sale. This law is set to sunset on January 1, 2020 (Revenue and Taxation Code (RTC) section 42024).

Under the law, a seller is defined as a person who sells prepaid MTS to another person in a retail transaction. This includes:

- indirect sellers such as third-party retailers, and
- direct sellers, such as prepaid MTS telecommunication service suppliers.

Telecommunication service suppliers who sell prepaid MTS directly to consumers are defined as "direct sellers." Persons other than direct sellers who sell prepaid MTS to consumers are typically referred to as "indirect sellers." Different registration, filing, and reporting requirements apply to indirect sellers than those that apply to direct sellers. AM section 0426.25 specifies the indirect seller requirements; AM section 0426.35 specifies the direct seller requirements. There is additional information in the *Prepaid Mobile Telephony Services (MTS) Surcharge* tax and fee guide.

SMALL SELLER EXEMPTION

Beginning January 1, 2017, indirect sellers with less than $15,000 of prepaid MTS sales in the prior calendar year are not required to charge and collect the surcharge from their customers. For sellers who have more than one location, sales of prepaid MTS from all locations must be used to determine annual sales.

Indirect sellers must maintain adequate records to show their annual prepaid MTS sales are less than $15,000. (Note: The $15,000 threshold is subject to annual adjustments by the Department of Finance.) The small seller exemption does not apply to direct sellers.

Customers who purchase prepaid MTS from indirect sellers who do not charge and collect the surcharge are responsible for reporting and paying the surcharge directly to the California Department of Tax and Fee Administration (CDTFA). Purchasers may report and pay their prepaid MTS surcharge on a one-time purchase through the CDTFA's online system. As a convenience to their customers indirect sellers, who qualify for the small seller exemption, may voluntarily collect the surcharge from their customers and report and pay the amounts to the CDTFA.

The law requires all sellers, including those meeting the small seller exemption, to be registered with the CDTFA to collect and remit the surcharge through December 31, 2016. On and after January 1, 2017, indirect sellers qualifying for the small seller exemption, and who do not voluntarily collect and remit the surcharge, are not required to be registered with the CDTFA. This includes indirect sellers who begin operating and selling prepaid MTS on or after January 1, 2017, and project prepaid MTS sales of less than $15,000 in the next calendar year. Nevertheless, any person claiming the small seller exemption must maintain the requisite documentation to support that their prior year's sales did not meet or exceed the minimum threshold (currently $15,000 to qualify as a small seller for the 2017 calendar year).

---

1 For purposes of this Audit Manual section when the term "prepaid MTS surcharge" is used, it refers to all three components of the surcharge: amounts for the emergency telephone users (prepaid 911) surcharge, the California Public Utilities Commission reimbursement fee and universal services surcharges, and any local charges imposed on prepaid MTS.

PREPAID MTS SURCHARGE RATE

The CDTFA is required to annually calculate the prepaid MTS surcharge rate by adding:

- The prepaid 911, surcharge rate as determined by the Office of Emergency Services (OES),
- The California Public Utilities Commission (CPUC) reimbursement fee and the telecommunications universal service surcharges, and
- Local charges, if any, which apply for the jurisdiction in which the sale occurs.

The CDTFA will post the combined total of the prepaid MTS surcharge rate and local rate(s) for each jurisdiction by December 1 of each year, to be effective the following January 1. Any new local charges and increases to existing local charges will be posted to the CDTFA's website by March 1 and be effective on April 1. A detailed breakdown of the current individual rates for the prepaid 911 surcharge, CPUC surcharges and fee, and a separate listing of local charges is available on the *Prepaid Mobile Telephony Services (MTS) Surcharge Rates* page, under the *Resources* section.

ITEMS SUBJECT TO THE PREPAID MTS SURCHARGE 0426.10

All prepaid wireless services and plans which customers purchase in predetermined units or dollars prior to using the service are subject to the prepaid MTS surcharge. The surcharge generally applies to sales of:

- Prepaid wireless airtime cards,
- Prepaid wireless cards compatible with pay-as-you-go cell phones,
- Prepaid wireless minutes,
- Prepaid wireless plans,
- Prepaid wireless refill or top-off cards,
- Prepaid SIM cards (with minutes/airtime),
- Prepaid wireless "e-Cards,"
- Prepaid mobile data or any other services when sold with any of the above,
- Any product or service (except a cell phone), when sold with prepaid MTS for a single non-itemized price, and
- A cell phone sold with prepaid MTS for a single non-itemized price, unless only a minimal amount of prepaid MTS is transferred. A minimal amount of prepaid MTS is $5 or less, or 10 minutes or less.

RETAIL TRANSACTIONS AND APPLICABLE RATES 0426.15

For purposes of collecting the prepaid MTS surcharge and local charge(s), a retail transaction occurs in this state if the prepaid consumer makes the retail transaction in person at a California business location (point-of-sale transaction). Furthermore, when the transaction does not occur in person at a California business location, the retail transaction is presumed to occur in California and the prepaid MTS surcharge applies when:

- The item is shipped/delivered to, or picked up by, a customer at a California location, or
- The seller's records show that the customer's address is located in California, or
- The customer provides an address in California during the sales transaction (for example, a billing address), or
- The mobile telephone number is associated with a location in California. This only applies if an address for the customer is not available.

Sellers making sales of prepaid MTS products/services from their business location should generally charge and collect the proper prepaid MTS surcharge rate for the city and/or county where the business is located. When the sale does not take place in person at the business location, but one of the above scenarios applies, the seller should charge the prepaid MTS surcharge rate that applies to the above known California location or address of the customer, in the order listed above.

LOCAL CHARGES 0426.20

Under the Local Prepaid Mobile Telephony Services Collection Act (RTC sections 42100-42111), cities and/or counties (local jurisdictions) that have an ordinance that applies its local charges to prepaid MTS *must* contract with the CDTFA to collect and administer its local charges on the sales of prepaid MTS. These local charges include utility user taxes (UUT), local 911 charges, and any other local charges for access to communication services that apply to prepaid MTS. Beginning January 1, 2016, if the local jurisdiction does not contract with the CDTFA, local charges imposed upon prepaid MTS will not be collected by sellers and the local jurisdictions will not receive local charge revenue from the sales of prepaid MTS in their jurisdiction.

Local jurisdictions that wish to contract with the CDTFA or have questions about the collection and administration of local charges with the prepaid MTS surcharge should be directed to the Local Revenue Branch (LRB) at (916) 324-3000, or by email at LRB-juri@CDTFA.ca.gov.

For detailed information about the local charges see the *Local Jurisdictions* section of the *Prepaid Mobile Telephony Services Surcharge* tax and fee guide.

INDIRECT SELLERS (THIRD-PARTY RETAILERS) — SM ACCOUNTS 0426.25

The Field Operations Division (FOD) and the Business Tax and Fee Division (BTFD) are responsible for the administration of indirect seller accounts. Indirect sellers of prepaid MTS have a Taxable Activity Type (TAT) of SM. The SM account requires separate registration and filing from other TATs. All indirect sellers of prepaid MTS are required to register for an SM account, even if they currently hold a seller's permit.

RETURN FILING FOR SM ACCOUNTS

Indirect sellers of prepaid MTS are required to electronically file their return quarterly with the CDTFA. The return for prepaid MTS is separate from returns filed for other CDTFA accounts. The prepaid MTS return will allow for the following deductions and exemptions:

- Sales to Other Retailers for the Purposes of Resale
- Out of State Transactions
- Surcharge (if any) included in Gross Sales of Prepaid MTS
- Bad Debt Losses on Sales of prepaid MTS
- Lifeline Exemption

REQUESTS FOR RELIEF

Online relief requests are available for SM accounts. Surcharge payers can file for relief of penalty, interest, or the collection cost recovery fee on the CDTFA's website. A Declaration of Timely Mailings (Form CDTFA-135-A) is also available to be filed online to support that the original return or payment was mailed timely.

PETITIONS AND CLAIMS FOR REFUND

In general, petitions and claims for refund for SM accounts follow the normal procedures currently in place for sales and use tax accounts.

Because the surcharge is imposed on the prepaid consumer, the seller (SM account holder) or the prepaid consumer may file a claim for refund directly with the CDTFA. The local jurisdiction is solely responsible for handling any claims regarding the validity of a local ordinance in its application to prepaid MTS, or interpreting any provision of their local ordinance (except to the extent superseded by these acts). The Audit Determination and Refund Section (ADRS) generally processes all claims received unless the claim pertains to local charges and is based on one of the issues in RTC section 42105 subdivisions (b), (c), or (d). When a claimant files a refund claim with the CDTFA pertaining to 1) the location of the retail transaction, 2) whether the consumer is exempt from the local charges under a local enactment, or 3) a claim citing the invalidity of a local tax ordinance, ADRS will direct the claimant to file the local charge portion of the claim with the appropriate local jurisdiction using form CDTFA-1492-CR, *Prepaid Mobile Telephony Services (MTS) Local Charge Refund Referral.*

AUDITS OF SM ACCOUNTS 0426.30

If a sales and use tax account selected for audit has a related SM account, audit staff should conduct an audit of the SM account. Audit staff will prepare a separate audit report for each account. SM audit reports follow existing digital audit procedures.

VERIFICATION OF ACCOUNT STATUS

Audit staff is responsible for verifying that sellers of prepaid MTS are properly registered and in compliance with the prepaid MTS program.

Agency Agreements

If a prepaid MTS retailer does not have a SM account because they claim they are the agent of the telecommunication service supplier (i.e., direct seller) with respect to their prepaid MTS sales, audit staff should ask to see a copy of the Agency Agreement between the retailer (store owner or operator) and the direct seller.

The Agency Agreement must be signed by both parties and must establish an agency relationship for purposes of prepaid MTS. The agreement should specify that the carrier is the seller of the prepaid MTS and the store owner/operator is only acting as an agent of the carrier in selling prepaid MTS and collecting any applicable taxes/fees imposed on the prepaid MTS, including the prepaid MTS surcharge and local charges.

When the retailer and direct seller have a valid Agency Agreement, audit staff should then verify that the direct seller is correctly registered with a TU account. If audit staff finds an error with the direct seller's TU account registration, they should contact the BTFD Compliance Branch's Registration and Licensing Section.

AUDIT REPORTS

Report of Field Audit

SM accounts have a separate audit case ID number from the audit case ID number of a related SR account. Audit staff will prepare a separate audit report for SM accounts using the Audit Forms (Start 21) and the Audit Workbook.

No Opinion Warranted (NOW) Reports for SM Accounts

An audit investigation of an SM account may result in a NOW audit recommendation. Audit staff should follow the same criteria as an SR account in determining if a NOW is appropriate. Audit staff should follow existing SR direction in preparing and completing the NOW, i.e., by using the Audit Summary Workbook or CDTFA-1010, *No Opinion Warranted Form*.

Transcript of Returns

Audit staff may upload the prepaid MTS transcript of returns filed for SM accounts in the same manner as SR accounts.

AUDIT PROCEDURES

Audit staff will conduct SM audits similar to sales and use tax audits, i.e., reconcile recorded to reported sales, verify claimed deductions, such as sales for resale, out-of-state sales, bad debts, etc., and include the following procedures:

Verification of Transactions Subject to the Prepaid MTS Surcharge

Audit staff will verify that the retailer is correctly collecting the surcharge on sales of prepaid MTS services and products. See AM section 0426.10 and the online tax and fee guide, *Prepaid Mobile Telephony Services Surcharge*, for guidance on transactions subject to the surcharge.

Verification of Correct Prepaid MTS Rates Charged

The prepaid MTS surcharge rate for each city and/or county is listed on the *Prepaid Mobile Telephony Services (MTS) Surcharge Rates* webpage. Audit staff will verify that the retailer is charging the correct prepaid MTS surcharge rate for their retail transactions. For guidance on what rate retailers should charge, see the online tax and fee guide, *Prepaid Mobile Telephony Services Surcharge*, under the MTS Rates tab. The guide includes links to an archive of prior year rates.

Unreported or additional sales subject to the prepaid MTS surcharge should be assessed at the proper rate, *including* any applicable local charges. However, because the CDTFA is not responsible for refunding local charges based on the issues described in RTC section 42105 subdivisions (b), (c), or (d), auditors should not allow an adjustment in the audit for either a refund or an offset of the local portion of the surcharge that involves any of these issues. In such circumstances, the surcharge payer should be directed to file a claim for refund or credit with the local jurisdiction (see AM section 0426.25). The statewide prepaid MTS surcharge rate is subject to annual adjustment.

Reimbursement Costs

Prepaid MTS sellers (other than direct sellers) may retain 2% of the prepaid MTS surcharge (including local charges) collected as reimbursement for part of their costs for collecting the prepaid MTS surcharge. The amount is claimed on the prepaid MTS return and reduces the overall surcharge liability. The reimbursement amount is automatically calculated and deducted on the SM return. Audit staff should verify that the retailer correctly reported their gross prepaid MTS sales prior to deducting the reimbursement costs.

Small Seller Exemption

Beginning January 1, 2017, prepaid MTS sellers (other than direct sellers) with less than $15,000 of prepaid MTS sales in the previous calendar year are no longer required to charge and collect the surcharge from their customers; see AM Section 0426.05. Sellers claiming the small seller exemption are required to maintain records of their prepaid MTS sales. Audit staff will verify that these sellers qualify for the small seller exemption.

Lifeline Exemption for Direct Sellers (RTC Section 42012)

Purchases by a consumer of prepaid MTS, either alone or in combination with mobile data or other services, are exempt if all of the following apply:

- The prepaid consumer is certified eligible for the state lifeline program or federal lifeline program.
- The seller is authorized to provide lifeline service under the state lifeline program or federal lifeline program.
- The exemption is applied only to the amount paid for the portion of the prepaid mobile telephony service that the lifeline program specifies is exempt from the surcharges and fees that comprise the prepaid MTS surcharge.

Generally, only TU accounts can qualify for the lifeline exemption because the statute requires that for the exemption to apply, the person selling the prepaid services to the consumer must be an authorized lifeline telecommunications service provider (i.e., service supplier). If an SM account claims exempt lifeline sales, audit staff should ask for documentation establishing that the retailer claiming the exemption is authorized to supply prepaid lifeline telecommunications services, and should investigate whether the seller should be registered as a TU account. A third party retailer cannot claim lifeline exempt sales on behalf of a direct seller.

AUDIT UPLOADS

SM audit report uploads will follow the existing procedures for SR accounts. One additional noncompliance code for “Lifeline Exemption” specific to prepaid MTS was added.

PURCHASER REGISTRATION (79B ACCOUNTS)

Beginning in June 2017, purchasers buying prepaid MTS for use in this state who did not pay the surcharge to a registered California retailer can report and pay the surcharge directly to the CDTFA. The online registration system allows purchasers to report and pay the surcharge on a one-time purchase of prepaid MTS.

TELECOMMUNICATION SERVICE SUPPLIERS (DIRECT SELLERS) — TU ACCOUNTS 0426.35

The BTFD is responsible for the administration of direct sellers’ accounts. A “direct seller” is defined as a prepaid MTS provider or service supplier (per RTC section 41007) who makes a sale of prepaid MTS (or prepaid wireless service) directly to a consumer in a retail transaction occurring in this state. A direct seller includes a:

- Telephone corporation (as defined in Public Utilities Code section 234), or
- An interconnected Voice over Internet Protocol (VoIP) service provider as defined in Public Utilities Code section 285, or
- A retailer (as defined in RTC section 6203) that is a member of the same commonly controlled group (as defined in RTC section 25105), or who is a member of the same combined reporting group (as defined in paragraph (3) of subdivision (b) of section 25106.5 of Title 18 of the California Code of Regulations, as an entity described above.

A direct seller is required to:

- Register with the CDTFA under the Emergency Telephone Users (911) Surcharge (ETUS) law, if not currently registered,
- Know the correct prepaid MTS surcharge rate and any applicable local rates,
- Charge and collect the prepaid MTS surcharge from its customers on sales of prepaid MTS,
- Electronically file and pay CDTFA-501-TE, Emergency Telephone Users Surcharge Return to the CDTFA,
- Pay the portion of the prepaid MTS surcharge that consists of the CPUC reimbursement fee and surcharges directly to the CPUC, and
- Pay any applicable local charges directly to the local jurisdiction or local agency imposing the local charge.

Direct sellers are registered under ETUS as a TU account. If the surcharge payer is currently registered under ETUS, they do not need to register again as a direct seller.

RETURN FILING FOR DIRECT SELLERS

Direct sellers must electronically file CDTFA-501-TE, *Emergency Telephone Users Surcharge Return*, include the portion of the prepaid MTS surcharge that consists of the prepaid 911 surcharge, and pay the reported amounts to the CDTFA. Direct sellers may claim bad debts related to prepaid MTS amounts subject to the surcharge (i.e., worthless accounts written off for income tax purposes) on the CDTFA-501-TE. Sales subject to the prepaid MTS surcharge should be reported net of sales that qualify for the section 42012 lifeline exemption (see AM section 0426.30).

Direct sellers must also pay the portion of the prepaid MTS surcharge that consists of the CPUC surcharges directly to the CPUC and pay any applicable local charges directly to the local jurisdiction or local agency imposing the local charge.

Refusal to Pay Schedule

TU accounts must submit CDTFA-507-TEA, *Refusal to Pay Schedule,* providing the names and addresses for any consumer who refuses to pay $3.00 or more of the ETUS and/or prepaid 911 surcharge. The BTFD Return Processing Branch will issue consumers listed on the schedule a Notice of Determination.

Billing Aggregator Schedule

TU accounts who report on behalf of another service provider can elect to electronically file a single return on behalf of multiple service providers. They must file a billing aggregator schedule (CDTFA-507-TE) identifying the total charges reported and total surcharge due on behalf of each service provider and their corresponding account number.

AUDIT PROCEDURES

Audit staff will conduct TU audits using the current procedures for special tax and fee audits and adding a reconciliation for the amount of prepaid 911 surcharge due based on the total prepaid MTS sold.

- Agency Agreements – For Information see AM section 0426.30, under *Verification of Account Status*.

PETITIONS AND CLAIMS FOR REFUND

Petitions and claims for refund follow the normal processes for TU accounts and are processed by the Appeals and Data Analysis Branch (ADAB). With the exception of petitions on Guaranteed Minimum Funding billings, explained in the following paragraph.

CALCULATION OF EMERGENCY TELEPHONE USERS SURCHARGE GUARANTEED MINIMUM FUNDING

Under section 41033 of the ETUS Law, the total collection for the prepaid 911 surcharge must total $9,900,000 per fiscal year, net of certain deductions and expenses. If the total collection results in less than $9,900,000, each direct seller will be issued a deficiency determination for their pro rata portion of the difference. Each determination will be on a pro rata basis based upon each direct seller's percentage share of total California intrastate prepaid MTS revenues for the prior fiscal year.

Beginning with the 2016–17 fiscal year and ending with the 2018–19 fiscal year, the Program Administration Branch will calculate the following on or before November 1 following the end of the respective fiscal year:

- The total collections for the fiscal year of the portion of the prepaid MTS surcharge that is for the prepaid 911 surcharge, net of any amounts that an indirect seller was permitted to deduct and retain pursuant to subdivision (e) of section 42010.
- Less costs incurred by the CDTFA for the fiscal year from that portion of the prepaid MTS surcharge that is for the prepaid 911 surcharge pursuant to subdivision (e) of section 42020.

The CDTFA will provide notification of whether the amount calculated exceeds or is less than $9,900,000 on its public website by December 15 following the calculation, along with the underlying calculations, assumptions, and methodology. Guaranteed Minimum Funding Deficiency Determinations will be issued to direct sellers, if necessary. Interest begins to accrue 60 days after the issuance of the billing.

- Petitions of Guaranteed Minimum Funding Deficiency Determinations

  Direct sellers who wish to contest a minimum funding deficiency determination have 60 days to file a petition for redetermination. If one direct seller timely appeals a minimum funding deficiency determination, all liabilities issued for the fiscal year will be automatically placed in petition status in IRIS. Appeals of the Guaranteed Minimum Funding Deficiency Determinations are acknowledged by the Appeals and Data Analysis Branch (ADAB). If the appeal involves contentions on the surcharge payer's market share, ADAB will forward the appeal to the California Public Utilities Commission for review. All direct sellers will receive a redetermination if one or more direct sellers successfully petition their billing.

CARDLOCK FUELING NETWORK TRANSACTIONS 0429.00

This section clarifies the application of sales and use tax to fuel sales made through a cardlock fueling network, provides guidance on how the tax applies and should be reported, and provides procedures for auditing SG accounts (sales tax prepayment accounts for fuel suppliers or wholesalers). For these purposes, a fuel supplier or wholesaler includes a person who:

1. Sells fuel to wholesalers, suppliers, or retailers; or
2. Sells fuel as a member in a cardlock network (cardlock operator)

DEFINITIONS 0429.01

A cardlock network transaction can have up to three parties involved in each network transaction. The industry uses the following terminology in its transactions:

- Customer – the party who purchases the fuel for use in his or her vehicle.
- Host Participant (Host) – A cardlock operator who physically provides the fuel.
- Foreign Participant (FP) – A cardlock operator who contracts with a customer for the sale of fuel. An FP can sell fuel from its own facilities or through a Host's facilities.

Following is a list of transaction categories commonly referred to in the cardlock industry and used in their billing statements. Bullets 2 and 3, below, describe the same transaction from the perspective of the Host and the FP, respectively. A "Foreign Sale" describes how the Host treats the transaction and a "Remote Sale" describes how the FP treats the exact same transaction:

- Domestic Sale – A transaction in which the customer's cardlock network operator (FP) is also the provider of the fuel (Host).
- Foreign Sale – A "resale" transaction in which fuel is provided by a Host to a customer on behalf of another in-state cardlock operator (FP). Both the Host and the FP are registered with the California Department of Tax and Fee Administration (CDTFA). The Host is making a sale of the fuel to the FP for purposes of resale to the FP's customer.
- Remote Sale (or "Foreign Purchase") – A "*retail*" fuel sale transaction made by an FP to its customer. The customer physically obtains the fuel from another cardlock operator (Host). The FP purchases the fuel from the Host for purposes of resale to its customer. The Host delivers the fuel to the customer on behalf of the FP and the FP charges the customer for the sale.
- "State of California – Sales Tax" transactions – A transaction where a customer of an out-of-state FP who is not registered with the CDTFA, purchases fuel in California at an in-state cardlock fueling network operator's facility (Host). The Host reports the sale as a retail sale directly to the customer.

CARDLOCK TRANSACTIONS – GENERAL DESCRIPTION 0429.05

A cardlock fueling network involves entirely self-service fuel facilities which are often located along the highway and in commercial or industrial areas. The cardlock network generally is used by commercial, industrial, or governmental fleet customers. The customers are issued encoded cards to access pumps throughout the network and are later billed for fuel purchases made through the cardlock network. In a typical cardlock agreement, a customer contracts to purchase fuel from a particular cardlock operator but is able to get fuel from any cardlock operator within the network. The cardlock network exists both within and outside of California. Therefore, a customer who has a cardlock purchase agreement with an in-state cardlock operator may physically obtain fuel at any in-state or out-of-state cardlock station within the network. Conversely, a customer who has a contract with an out-of-state cardlock operator may obtain fuel from any California cardlock station or at any other out-of-state cardlock station within the network.

Each FP has its own customers to whom it issues network cards. To obtain a network card, the customer enters into an agreement with an FP for the sale of fuel at a specified price. This price is confidential. Thus, for non-domestic sales, whenever a sale of fuel is made within the network, the Host (the station providing the fuel) is generally not apprised of the retail selling price of the fuel. For its participation in the sale, the Host is reimbursed for its cost of fuel, actual freight charges for the fuel, and an agreed upon network surcharge.

Cardlock networks utilize a transaction processor (clearinghouse) that issues regular reports summarizing the transactions made by each cardlock operator. Auditors must obtain all copies of these reports for the entire audit period. For example, Pacific Pride and Commercial Fueling Network (CFN) are the names of two transaction processors that provide these reports. The report provides the following information about each cardlock station:

- How much fuel it provided to its own customers.
- How much fuel it provided to customers of other FPs in the network (transactions in which the operator was the Host – these are resale (foreign) transactions).
- How much fuel its customers received from other Hosts in the network (transactions in which the other cardlock operator was the FP – these are retail (remote) transactions).
- Each report itemizes gallons transferred and the federal and state taxes collected or paid during the reporting period.
- For transfers of fuel to non-permitted, out-of-state fuel members, the auditor should ask the taxpayer how they identify these transactions using the transaction processor report. Generally these will be separated from other transactions in which the processor is the host. Typically, the tax amounts of these transfers are provided.

The following examples clarify the distinction between "foreign" and "remote":

<u>Example A</u>

There are two in-state cardlock operators making cardlock network sales, Operator X and Operator Y. Operator X reviews its cardlock report and sees that in its first transaction it provided fuel to a customer of Operator Y. This is a "foreign sale" for Operator X and it is the Host. Operator X has made a sale for resale to Operator Y. As the foreign participant, Operator Y will bill its customer for the retail sale of fuel at the price agreed upon by Operator Y and its customer (the contract price). Operator Y is the retailer and must report the transaction as a taxable retail sale under its seller's permit account.

Example B

In another transaction involving two in-state cardlock operators, Operator X sees that its customer went to the station of Operator Y and received fuel. This is a "remote sale" for Operator X because its customer went to a different (remote) location (i.e., Operator Y's location) to obtain fuel. Since Operator X has the cardlock contract with the customer, Operator X is the retailer of the fuel (not Operator Y) and must report the transaction as a taxable retail sale under its seller's permit account. Operator Y has made a sale for resale to Operator X.

REPORTING CARDLOCK SALES 0429.10

A California cardlock operator is required to have an "SG" permit (issued to suppliers and wholesalers of fuel) and report on a form CDTFA 401-DB – *Prepayment of Sales Tax on Fuel Sales*, (often referred to as the "SG Return"). The cardlock operator is required to hold an "SG" permit because it is generally a wholesaler in all transactions in which it makes non-retail sales of fuel to other cardlock operators as the Host. The SG return has two schedules:

- The CDTFA-531-AB (*Schedule A*), is where the Host reports its sales for resale to FPs. On this schedule, the operator includes all gallons sold to and prepaid sales tax collected from other FPs, listed separately by the FP's seller's permit number, in the network during the reporting period. It also includes sales made to its customers at its own stations because it is both the Host and the FP for these transactions. The Host reports these sales on the first line of Schedule A, as sales made under the Host's own seller's permit number.
- The CDTFA-531-AB (*Schedule B*), the operator reports all fuel gallons purchased and all prepaid sales tax it has paid to other wholesalers (cardlock network operators) or suppliers when it purchases fuel for resale.

The cardlock operator also has a California seller's permit because it is a retailer in all FP transactions. Retail sales of fuel are reported on the CDTFA-401-GS *Sales & Use Tax Return* along with the CDTFA-531-G (*Schedule G*) to report fuel purchases and claim a credit for the sales tax prepaid to others (here, the prepaid sales tax amounts are "collected" from itself as the Host which were reported on line 1 of Schedule A to the cardlock operator's SG return).

Who is Responsible for the Tax Due on Each Transaction?

Reporting for cardlock transactions is generally dependent on whether the fuel is purchased in state or out of state and whether the fuel is purchased by a customer who has contracted with an in-state registered cardlock operator or an out-of-state unregistered cardlock operator. Following are specific examples:

1. Customer purchases fuel in state from the cardlock facilities of its own California cardlock network operator. This is classified as a "domestic transaction." The Host and the FP is the same cardlock operator in these transactions. On the cardlock operator's SG Return Schedule A, line 1, it must report the transaction as a sale made to its retail seller's permit account and state the gallons sold and prepaid sales tax collected from its own retail seller's permit account (just as it would report prepaid sales tax collected on a sale to any other FP). On its sales tax return, it must report sales tax on the retail selling price of the fuel at the contracted amount and claim the Schedule G credit for the prepaid sales tax on the corresponding Schedule G (this should be the same amount as the prepaid sales tax that it reported as sold to its retail seller's permit account on line 1 of the SG return Schedule A). Prepaid sales tax collected from other wholesalers and reported on Schedule A, line 2 and onwards, are not creditable and cannot be claimed on Schedule G The following sales and use tax returns and schedules are filed for this transaction type:
   Host/FP: SG permit #78-020xxx and SR permit #29-671xxx

- **401-DB** – to report gallons sold to and prepaid sales tax received from its related retail account (the FP)
- **Sch A** – to report gallons sold to and prepaid sales tax collected from its related retail account (FP's SR 29-671xxx)
- **401-GS** – to report retail sale to customer with whom it has a contract
- **Sch G** – to claim the credit for prepaid sales tax remitted to its related wholesale account (the Host's SG 78-020xxx permit)

2. Customer purchases fuel in state from the cardlock facilities of another California cardlock network operator.

   This is classified as a "foreign transaction." The Host and the FP are different cardlock operators in this example. The Host is the wholesaler in this transaction and will report the sale as a "sale for resale" to the FP with whom the customer has its contract. When the Host charges the FP for the fuel sale, it must collect sales tax prepayments from the FP at the prepayment rate and report the prepaid sales tax collected from the FP, and the corresponding gallons sold to the FP, on Schedule A of the Host's SG return.

   The FP is the retailer of the fuel. The sale is reported by the FP as a taxable transaction (at the contract price of the fuel) and the FP will claim a credit on Schedule B of their SG return for the prepaid tax remitted to the Host. The FP must report district taxes based on the location of the Host, because that is where the fuel was delivered to the customer.

   The following sales and use returns/schedules are filed for this transaction type:

   Host: SG permit #78-020xxx and SR permit #11-232xxx

   - **401-DB** – to report prepaid sales tax collected and gallons resold that are subject to prepayment
   - **Sch A** – to report prepaid sales tax collected from and gallons resold to FP SG #78-092xxx

   FP: SG permit #78-092xxx and SR permit #29-671xxx

   - **401-DB** – to report prepaid sales tax paid to Host and "collected" from FP's own retail account (SR #29-671xxx)
   - **Sch B** – to report prepaid sales tax paid to and gallons purchased from Host SG #78-020xxx
   - **Sch A** – to report prepaid sales tax collected from and gallons resold to FP's retail account SR #29-671xxx
   - **401-GS** – to report sale to customer as a taxable retail sale (Line 12). Allocate local tax to the location of the FP. Allocate district tax (if applicable) to the location of the Host.
   - **Sch G** – to claim credit for prepaid sales tax to FP SG #78-092xxx

3. Customer purchases fuel from the cardlock facilities of an out-of-state location of an unregistered cardlock network operator.

   Since the delivery of the fuel to the customer of the California cardlock network operator did not take place in California, the sale is considered a sale in interstate commerce by the California FP and should not be reported as a taxable transaction by the FP.

   The following returns are filed for this transaction type:

   FP: SR permit # 29-671xxx

   - **401-GS** – to include sale to customer in Line 1 (Total Sales) but deduct as an exempt interstate commerce sale.

Host: No return is filed by the Host because it is an out-of-state retailer that is not required to have a California seller's permit.

4. Customer of an out-of-state unregistered cardlock network operator purchases fuel in California at a California network operator's cardlock facility.
   This is the transaction type that causes the most reporting errors. When an out-of-state cardlock network operator is not registered in this state, the sales to their customers in this state are taxable and must be reported by the California network operator (Host) since deliveries of fuel were made in California (pursuant to RTC Section 6007). The transaction is handled similarly to those made by a cardlock operator that is both the Host and the FP. The auditor should ask the taxpayer how it identifies these transactions using the transaction processor report. Generally these will be separated from other transactions in which the processor is the host. On the CFN report, these transactions will be listed under tax code 0501 "*State of California – Sales Tax.*" All other Host transactions are listed under tax code 0502 "*Calif Pre-Pay Sales Tax PrePay Gas Tax.*"
   - The in-state SG supplier (Host) will report the gallons sold as a sale to its SR account. It will collect prepaid sales tax from its SR account.
   - The full selling price must be reported on the SR sales tax return with credit allowed on its *Schedule G* for the related prepaid sales tax. Although the California Host will generally not be privy to the contracted selling price of the fuel between the FP and the customer, it is not relieved from its liability for sales tax on the full contracted retail selling price. Pursuant to RTC Section 6007 and Regulation 1706, *Drop Shipments*, the Host may mark-up the cost of fuel 10 percent and report that as the retail selling price. The Host may also use a mark-up percentage lower than 10 percent if it can document the lower mark-up percentage accurately reflects the contracted retail selling price charged by the FP to its customer.

The following returns are filed for this transaction type:

Host: SG permit #78-020xxx and SR permit #29-671xxx

401-DB – to report the prepaid sales tax received from its related account (Host's "retail account").

Sch A – to report the gallons sold to and prepaid sales tax collected from its related account (Host's retail account).

401-GS – to report the sale made to the customer as a taxable transaction. Allocate both the local tax and the district tax (if applicable) to the location of the Host's station.

Sch G – to claim credit for the prepaid tax paid to the Host's wholesale account.

FP: No return filed by the foreign participant because it is an out-of-state retailer that is not required to have a California seller's permit.

5. The customer is not a member of the cardlock network and uses a traditional method of payment for the fuel (e.g., debit or credit card).

   This situation is similar to Example #1 in which the Host and the FP are the same entity and the sales should be reported in the same manner. However, these transactions will NOT appear on the cardlock operator's report from the clearinghouse because they are not purchased under a cardlock account. The operator should maintain separate records to document these types of transactions/sales. The auditor should ask about these transactions in every cardlock audit and request the appropriate documentation.

SG AUDITS 0429.15

When performing an audit of an SG account, fuel sales reported as "Total Removals, Entries or Sales (in gallons)" on the SG return should be examined in detail, especially when credit returns are regularly filed. Below are some common reasons taxpayers file credit returns. This list is not all inclusive.

- More fuel gallons are purchased than sold for stated periods (timing difference).
- In-state cardlock transactions to customers of out-of-state participants are not being reported on line 1 of the SG return and SR return (Example # 4 above). This information can be obtained by asking the taxpayer how sales to out-of-state participants are recorded and reported. On the report from the clearinghouse sent to the supplier, these transactions are listed in the category labeled tax code 0501 - "Foreign Taxes You Received From Other Participants-State of California-Sales Tax."
- Claimed exemptions for fuel sold out-of-state, for resale, or to the U.S. government.

UNDERGROUND STORAGE TANK MAINTENANCE FEE AUDITS 0429.17

The Audit Examination Branch (AEB) within the Audit and Carrier Division (ACD) is responsible for performing Underground Storage Tank Maintenance Fee audits. The fee is assessed on the owner of the UST for each gallon of petroleum products placed into an underground storage tank (UST). Petroleum products subject to the fee include, but are not limited to, gasoline, diesel, waste oil, and heating oil. Whenever possible, the auditor should use the SG return amounts to verify the reported amounts on the UST return. Any differences between Schedule A and Schedule G of the SG return should be examined in detail.

AUDIT DETERMINATION AND REFUNDS (ADRS) 0429.20

The Refund Support and Gas Unit within ADRS is responsible for processing refunds resulting from credit returns filed under the SG tax program. ADRS tracks and maintains schedules showing refunds issued to SG suppliers. These schedules often reflect instances where it seems more fuel gallons are purchased than sold for stated periods. ADRS sends audit leads to the offices to determine whether excessive refunds have been issued related to the in-state cardlock network sales to purchasers from out of state. Please be aware there may be erroneous refunds which can be recovered within statute. ADRS will hold current claims for refund for these accounts (credit returns) in abeyance pending completion of the office investigations.

If a liability exists for the SG account, an audit should be prepared with a credit allowed on the audit of the related SR account. When allowing this credit, the auditor must add a comment to the back of the CDTFA 414-A (*Report of Field Audit)* stating that ADRS needs to manually adjust credit interest to equal the debit interest rate and include a schedule 20-G3 (*Prepayment of Tax on Fuel Purchases Reconciliation*). See AM Section 0433.15. In order to ensure that the credit interest is calculated and applied correctly, both the SG and SR audits must be transmitted to Headquarters at the same time.

ALLOCATION OF LOCAL AND DISTRICT TAXES FOR TRANSACTIONS INVOLVING A HOST AND FOREIGN PARTICIPANT 0429.25

The local and district taxes (if applicable) should be allocated as follows for FP and Host transactions when the foreign participant is engaged in business in this state and the contract is negotiated at the foreign participant's in-state location:

- Local tax - The location of the place of business of the FP where the contract was negotiated is the place of sale for local tax purposes.
- District tax - The sale is generally subject to the district use tax, if any, of the location where the Host delivered the fuel to the customer. For purposes of collecting the tax, the FP is considered engaged in business in the district.

Where the foreign participant is not engaged in business in this state, per RTC section 6007(a)(2), the sale is deemed to be a retail sale by the host participant in California. The applicable local tax is that of the location of the host participant's place of business. If the host participant is located in a taxing district, the transactions tax of that district (or districts) applies to the sale.

(Annotation 700.0210, *Sales by Fueling Network,* provides additional detail regarding local and district taxes).

<u>Local and district tax allocation examples</u>:

Host is located in Sacramento. The contract with the FP was negotiated at the FP's location in San Mateo. When the FP's customer obtains fuel from the Host, the FP is deemed to be the retailer. The FP's headquarters are located in San Mateo and that is where the negotiation of the transaction occurred, thus, the local tax should be allocated to that city. However, the fuel was delivered in Sacramento. Accordingly, the Sacramento district tax is due and not the San Mateo district tax. The FP, as the retailer, is liable for the Sacramento district tax.

AUDIT OF MOTOR VEHICLE FUEL 0430.00

GENERAL 0430.05

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

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

AUDITING PROCEDURE 0430.10

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

METHODS OF VERIFICATION 0430.15

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

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

ACQUISITION OF EX-TAX GASOLINE 0430.20

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

AUDIT OF MOTOR VEHICLE FUEL RETAILERS — PREPAYMENT OF SALES TAX 0431.00

GENERAL 0431.05

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

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

REPORTING REQUIREMENTS 0431.10

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

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

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

AUDITING PROCEDURES 0431.15

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

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

PROCEDURES WHERE RETAILER IS ALSO A SUPPLIER/WHOLESALER 0431.20

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

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

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

LOCAL TAX ALLOCATION 0431.25

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

BAD DEBTS 0431.30

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

ELIGIBILITY FOR REMOVAL FROM PREPAYMENT STATUS 0431.35

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

CLOSE-OUTS 0431.40

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

WORKING PAPERS 0431.45

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

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

SPECIAL MOTOR VEHICLE FUEL TRANSACTIONS 0432.00

RETAILERS WHO PREMIX OR BLEND MOTOR VEHICLE FUEL AND LUBE OIL 0432.10

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

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

RETAILERS WHO PURCHASE PREMIX FROM A SUPPLIER 0432.15

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

CREDIT CARD SALES 0432.20

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

MASTER CONTRACT SALES 0432.25

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

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

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

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

SALES TO THE U.S. GOVERNMENT 0432.30

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

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

SALES TO LOCAL GOVERNMENTS 0432.35

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

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

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

SALES OF GASOLINE FOR USE IN AIRCRAFT 0432.40

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

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

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

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

SALES TO AIRCRAFT COMMON CARRIERS AND WATER COMMON CARRIERS 0432.45

Effective July 15, 1991, sales of fuel and petroleum products delivered to the purchasing carriers in California are subject to sales tax except as provided by Regulation 1621(b)(3)(B) for air common carriers. The seller must obtain an exemption certificate (See Regulation 1621) from the common carrier to support the claimed exemption. Between July 15, 1991, and December 31, 2002, a similar exemption existed for water common carriers. The water common carrier exemption was discontinued from January 1, 2003, to March 31, 2004. The exemption was reinstated April 1, 2004, and remains in effect through December 31, 2028. See Revenue and Taxation Code section 6357.5 and 6385 for more details.

SALES TO AUTO LEASING FIRMS 0432.50

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

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

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

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

SALES TO LESSORS OF MOBILE TRANSPORTATION EQUIPMENT 0432.55

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

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

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

REFUND OF SALES TAX ON FEDERAL EXCISE TAX REFUNDS 0432.65

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

AUDIT OF FUEL DISTRIBUTORS/BROKERS — PREPAYMENT OF SALES TAX 0433.00

GENERAL 0433.05

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

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

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

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

PREPAYMENT CREDITS 0433.10

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

AUDITING PROCEDURE 0433.15

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

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

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

REPORTING ERRORS 0433.20

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

AUDIT WORKING PAPERS 0433.25

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

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

BAD DEBTS 0433.30

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

LOCAL TAX ALLOCATION 0433.35

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

NEW CAR DEALERS 0433.40

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

CREDIT OFFSETS 0434.00

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

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

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

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

PERIOD	Taxable Measure per Audit Determination	Claim for Refund (Bad Debts not Claimed)	Offsets	Overpayments Outside Statutes (Disallowed)	Measure of Tax per Reaudit (B-C-D)
2-94	$15000	$81000	$-81000		0
3-94	19000	0	0		0
4-94	30000	0	0		0
1-95	9000	-50000	-50000		0
2-95	5000	-33000	-33000		0
3-95	12000	-40000	-15000	-25000	0
4-95	23000	-44000		-44000	0
1-96	24000	0			0
2-96	10000	-15000			-15000
3-96	13000	0			0
4-96	4000	-22000			-22000
1-97	15000	-10000			-10000
Totals	$179000	$-295000	$-179000	$-69000	$-47000

NOTES:

1. Notice of Determination issued on 10/01/98 for the audit period 04/01/94 to 03/31/97. Determination will become final on 10/31/98 or is in petition status.
2. Claim for refund filed 03/01/99 for bad debts not claimed and not adjusted in the audit. Claim for refund timely for statutory period 01/01/96 to 03/31/97. Claim for refund also opens period 04/01/94 through 12/31/95 for offsets to 0.
3. Overpayments starting with the earliest period of the claim applied against the total taxable measure per audit determination until it is completely offset.
4. Remaining overpayments outside statutory period of the claim disallowed.
5. Remaining overpayments within statutory period of claim that are available for refund.

CLAIM FOR REFUND FILED WHEN AUDIT DETERMINATION NOT IN PETITION STATUS OR MORE THAN SIX MONTHS AFTER FINALITY DATE 0434.10

When a claim for refund is filed for overpayments that were made during a period for which an audit determination was issued and the determination is not in petition status and the claim is filed more than six months after the determination became final, only the overpayments made within the statutory period of the claim (i.e. three years from the date that the claim was filed) are available to apply as credit offset adjustments. The overpayments made within the statutory period of the claim may be offset against corresponding quarterly liabilities on a quarter by quarter basis. The overpayments outside of the statutory period of the claim cannot be used to offset liabilities and are disallowed.

Accordingly, the overpayments within the statutory period of the claim will be applied in the quarter that they occurred against corresponding quarterly liabilities (Col. C below). No credit offsets will be made outside of the statutory period of the claim. The following example illustrates these procedures.

	(A)	(B)	(C)	(D)	(E)
Periods	Taxable Measure per Audit Determination	Claim for Refund (Bad Debts not Claimed)	Overpayments Allowed	Overpayments Outside Statutes (Disallowed)	Measure of Tax per Reaudit (A+C)
2-94	$15000	$-81000		$-81000	$15000
3-94	19000	0		0	1900
4-94	30000	0		0	30000
1-95	9000	-50000		-50000	9000
2-95	5000	-33000		-33000	5000
3-95	12000	-40000		-40000	12000
4-95	23000	-44000		-44000	23000
1-96	24000	0		0	2400
2-96	10000	-15000	$-15000		-5000
3-96	13000	0	0		1300
4-96	4000	-22000	-22000		-18000
1-97	15000	-10000	-10000		5000
Totals	$179000	$-295000	$-47000	$-248000	$132000

NOTES:

1. Notice of Determination for the original audit issued on 08/01/98 for the audit period of 04/01/94 to 03/31/97. Determination became final on 08/31/98.
2. Claim for refund filed 03/01/99 for bad debts not claimed and not adjusted in the audit. Claim for refund timely for refund purposes for statutory period 01/01/96 to 03/31/97. Claim for Refund not timely for offset purposes for period 04/01/94 to 12/31/95.
3. Overpayments within the statutory period of the claim applied against corresponding quarterly liabilities.
4. Overpayments outside statutory period of claim disallowed.

SPLIT BILLINGS 0434.15

When a claim for refund is filed for overpayments that were made during an audit period for which both a phone-in determination and an audit determination were issued, offset rules will apply to each determination separately.

If the claim for refund is filed while the phone-in determination is in petition status or within six months of the date that the phone-in determination became final, the period of the phone-in determination is open to adjustment. Overpayments claimed during this period may be offset against the amount of the phone-in liability even if the overpayments are beyond the statutory period of the claim. If any overpayments remain after the phone-in liability is offset, they may be refunded to the taxpayer *if they are within the statutory period of the claim*. Any remaining overpayments outside of the statutory period of the claim may not be refunded to the taxpayer nor offset against the audit determination. Such remaining overpayments should be disallowed.

Additionally, if the claim for refund is filed while the audit determination is in petition status or within six months of the date that the audit determination became final, the period of the audit determination is open to adjustment. Overpayments claimed during this period, beginning with the earliest, may be offset against the total liability for the audit determination even if the overpayments are beyond the statutory period of the claim. If the total liability of the audit determination is offset, any remaining overpayments *within the statuary period of the claim* may be refunded to the taxpayer. Any remaining overpayments outside the statutory period of the claim may not be refunded to the taxpayer. Such remaining overpayments should be disallowed.

Only overpayments that fall within the period of the phone-in determination, can be offset against that determination. Likewise, only overpayments that fall within the period of the audit determination can be offset against that determination. The following examples illustrate some applications of offsets when a claim for refund is filed timely for audit periods covered by an audit determination but not timely for periods covered by a phone-in determination.

CLAIM FOR REFUND FILED TIMELY FOR AUDIT DETERMINATION BUT NOT FOR PHONE-IN DETERMINATION 0434.20

Periods	(A) Taxable Measure per Phone-In Determination	(B) Taxable Measure per Audit Determination	(C) Claim for Refund (Bad Debts)	(D) Offsets	(E) Overpayments Outside Statutes (Disallowed)	(F) Taxable Measure per Phone-In (A-D)	(G) Taxable Measure per Reaudit (C-D-E)
2-94	$15000		$-81000	$0	$-81000	$15000	$0
3-94		19000	0	0			0
4-94		30000	0	0			0
1-95		9000	-50000	-50000			0
2-95		5000	-33000	-33000			0
3-95		12000	-40000	-40000			0
4-95		23000	-44000	-41000	-3000		0
1-96		24000	0				0
2-96		10000	-15000				-15000
3-96		13000	0				0
4-96		4000	-22000				-22000
1-97		15000	-10000				-10000
Totals	$15000	$164000	$-295000	$-164000	$-84000	$15000	$-47000

Notes:

1. 2–Q–94 liability phoned-in on 07/20/97, determination issued on 07/25/97, and became final on 08/25/97.
2. Waiver was obtained through 10/31/98 and the audit determination was issued on 09/15/98 for the period 07/01/94 to 03/31/97. The determination became final on 10/15/98.
3. Claim for refund filed on 03/01/99. Neither phone-in nor audit determination in petition status. Claim for refund not timely for refunds or offsets for 2–Q–94 liability per phone-in determination (beyond six months of finality date). However, claim for refund is timely for audit determination for purposes of offsets for period 07/01/94 to 12/31/95 and refunds for statutory periods of 01/01/96 to 03/31/97 (within six months of finality date).
4. Overpayments, beginning with the earliest made during the period of the audit determination, applied against the total taxable measure per audit determination until it is completely offset.
5. Balance of overpayments within statutory period of claim that are available for refund.

APPLICATION OF OVERPAYMENTS TO EXPIRED LIABILITIES BUT WITHIN THE CLAIM FOR REFUND PERIOD 0434.30

A timely filed Claim for Refund opens up the entire claim period to the assessment of underpaid tax as well as overpaid tax. This is true even if the statute of limitations for part or all of the claim period has otherwise expired. As such, even though the Board of Equalization is barred from issuing a deficiency determination for the expired periods, auditors should apply any underpayments discovered to the verified overpayments up to the point the claim is reduced to zero. Underpayments may be offset against any overpayment period within the claim, not just the period in which the underpayment occurred. However, if an underpayment occurred in an expired period that is not included in the Claim for Refund, it cannot be used to offset any overpayments.

In the following examples, a timely Claim for Refund was received for the period 1Q02-2Q04. Subsequently, based upon the volume of records required to validate the claim, it was decided to audit the taxpayer's records and a waiver for the period 3Q04 & 4Q04 was obtained to protect the statute of limitations. Column C represents the allowable refund measure for each period and Column F represents the additional debit measure disclosed in the audit. Column G is the net debit or credit measure. Column H displays the periods with net credits that may be offset by debit measure from other periods. Credit measure should be offset in the earliest periods first. For example, the credit disclosed in 2Q02 (-$10,000) should be applied to the 1Q02 liability ($30,000) and not subsequent liabilities. Doing so minimizes the impact of fluctuations in quarterly debit and credit interest.

In Example 1, total debit measure of $790,000 is disclosed for the claim period. After the claimed credit amounts are offset by the additional debit measure disclosed, a net credit measure of $10,000 is remaining for the claim period. This amount is included in Column K, "Measure per Audit" and will be refunded to the taxpayer.

In Example 2, total debit measure of $830,000 is disclosed for the claim period. Of that amount, $800,000 is offset by available credits. The balance of $30,000 cannot be assessed or offset and is excluded from Col K, "Measure per Audit."

APPLICATION OF OVERPAYMENTS TO EXPIRED LIABILITIES BUT WITHIN THE CLAIM FOR REFUND PERIOD (CONT. 1) 0434.30

In Example 1, total debit measure of $790,000 is disclosed for the claim period. After the claimed credit amounts are offset by the additional debit measure disclosed, a net credit measure of $10,000 is remaining for the claim period. This amount is included in Column K, "Measure per Audit" and will be refunded to the taxpayer.

REF	PERIOD	CREDIT MEAS..	DEBIT MEAS.	DEBIT MEAS.	TOTAL DEBIT MEAS.	NET MEAS.	CREDITS AVAILABLE TO OFFSET OUTLAWED DEBITS	OUTLAWED DEBITS	OFFSETS	MEASURE PER AUDIT
1	1Q-02	-100,000	60,000	70,000	130,000	30,000		30,000	-30,000	0
2	2Q-02	-20,000	10,000	0	10,000	-10,000	-10,000		10,000	0
3	3Q-02	-80,000	10,000	30,000	40,000	-40,000	-40,000		40,000	0
4	4Q-02	-50,000	110,000	10,000	120,000	70,000		70,000	-70,000	0
5	1Q-03	-50,000	10,000	60,000	70,000	20,000		20,000	-20,000	0
6	2Q-03	-220,000	10,000	30,000	40,000	-180,000	-180,000		180,000	0
7	3Q-03	-30,000	60,000	140,000	200,000	170,000		170,000	-170,000	0
8	4Q-03	-90,000	120,000	10,000	130,000	40,000		40,000	-40,000	0
9	1Q-04	-40,000	10,000	10,000	20,000	-20,000	-20,000		20,000	
10	2Q-04	-120,000	20,000	10,000	30,000	-90,000	-90,000		80,000	-10,000
Claim Period Total		**-800,000**	**-420,000**	**-370,000**	**-790,000**	**-10,000**	**-340,000**	**330,000**	**0**	**-10,000**
11	3Q-04	-50,000	0	0	0	-50,000	0	0	0	-50,000
12	4Q-04	-220,000	0	0	0	-220,000	0	0	0	-220,000
13	1Q-05	-30,000	0	0	0	-30,000	0	0	0	-30,000
14	2Q-05	-150,000	0	0	0	-150,000	0	0	0	-150,000
15	3Q-05	0	0	0	0	0	0	0	0	0
16	4Q-05	0	0	0	0	0	0	0	0	0
17	1Q-06	0	0	0	0	0	0	0	0	0
18	2Q-06	0	0	0	0	0	0	0	0	0
19	Totals	-1,250,000	420,000	370,000	790,000	-460,000	-340,000	330,000	0	-460,000

There is a net refund for the claim period. All debits may be offset and the net credit amount for the claim period is subject to refund or offset to periods still open under the statutes.

The difference between the totals of Column C and Column F must be equal to either a credit amount or zero (0). It cannot be a debit amount.

The difference between the total of Column C and Column F must equal Column K for the Claim Period (1Q02-2Q04).

The totals in Column K reflect the credit allowed after applying all offsets as well as that portion of the refund for which either a waiver of limitation was secured or the periods are still open under the three year statute.

Application of Overpayments to Expired Liabilities But Within the Claim for Refund Period (Cont. 2) 0434.30

In Example 2, total debit measure of $830,000 is disclosed for the claim period. Of that amount, $800,000 is offset by available credits. The balance of $30,000 cannot be assessed or offset and is excluded from Col K, "Measure per Audit."

REF	PERIOD	CREDIT MEAS..	DEBIT MEAS.	DEBIT MEAS.	TOTAL DEBIT MEAS.	NET MEAS.	CREDITS AVAILABLE TO OFFSET OUTLAWED DEBITS	OUTLAWED DEBITS	OFFSETS	MEASURE PER AUDIT
1	1Q-02	-100,000	60,000	70,000	130,000	30,000		30,000	-30,000	0
2	2Q-02	-20,000	10,000	0	10,000	-10,000	-10,000		10,000	0
3	3Q-02	-80,000	10,000	30,000	40,000	-40,000	-40,000		40,000	0
4	4Q-02	-50,000	110,000	10,000	120,000	70,000		70,000	-70,000	0
5	1Q-03	-50,000	10,000	60,000	70,000	20,000		20,000	-20,000	0
6	2Q-03	-220,000	10,000	30,000	40,000	-180,000	-180,000		180,000	0
7	3Q-03	-30,000	60,000	140,000	200,000	170,000		170,000	-170,000	0
8	4Q-03	-90,000	120,000	10,000	130,000	40,000		40,000	-40,000	0
9	1Q-04	-40,000	10,000	10,000	20,000	-20,000	-20,000		20,000	
10	2Q-04	-120,000	20,000	10,000	30,000	-90,000	-90,000		80,000	-10,000
Claim Period Total		**-800,000**	**-420,000**	**-370,000**	**-790,000**	**-10,000**	**-340,000**	**330,000**	**0**	**-10,000**
11	3Q-04	-50,000	0	0	0	-50,000	0	0	0	-50,000
12	4Q-04	-220,000	0	0	0	-220,000	0	0	0	-220,000
13	1Q-05	-30,000	0	0	0	-30,000	0	0	0	-30,000
14	2Q-05	-150,000	0	0	0	-150,000	0	0	0	-150,000
15	3Q-05	0	0	0	0	0	0	0	0	0
16	4Q-05	0	0	0	0	0	0	0	0	0
17	1Q-06	0	0	0	0	0	0	0	0	0
18	2Q-06	0	0	0	0	0	0	0	0	0
19	Totals	-1,250,000	420,000	370,000	790,000	-460,000	-340,000	330,000	0	-460,000

(1) Offsets can only be applied to debits using credits within the claim period. The available credits during the claim period totalled $300,000 and the debits disclosed were $330,000. The remaining debit measure of $30,000 cannot be assessed due to the statute of limitations. The measure of tax will only include post claim period credits and debits.

The difference between the total of Column C and Column F during the claim period must be equal to either a credit amount or zero (0). It cannot be a debit amount. In the example above, the $30,000 remaining debit amount on Line 8 was eliminated because there was no remaining credit measure in the claim period.

The difference between the total of Column C and Column F will not equal Column K for the claim period (1Q02-2Q04). The totals in Column K reflect the credit allowed after applying all offsets as well as that portion of the refund for which either a waiver of limitation was secured or the periods are still open under the three year statute.

OFFSETTING INTEREST ON CLAIMS FOR REFUND FILED DURING AN AUDIT 0434.32

The efficiency of the audit process is improved by discussing the possibility of claims for refund with the taxpayer at the opening conference. To avoid delaying the timely completion of an audit, the auditor should make every effort to obtain any claims for refund as soon as possible.

Refund claims filed with supporting documentation are to be included as part of the audit report when there is sufficient time to address the adjustments in the AWPs. Generally, if a taxpayer files a claim for refund prior to the completion of the audit (i.e., the exit conference), and the taxpayer provides complete and acceptable supporting documentation, the auditor should process the refund claim as part of the audit report with credits offsetting the liabilities during the audit period. Districts should consider whether to hold or transmit the audit based on the best interest of the board and the taxpayer, considering such issues as the size of the account, number of claims involved, etc. If the claim is filed prior to completion of the audit but additional time is requested to compile supporting documentation which, when considering the time to verify the documentation, will delay the audit more than ninety (90) days, the claim should generally be processed separately as a reaudit. If the refund claim includes periods outside of the audit period, the portion of the claim outside the audit period should be processed as a Field Billing Order (FBO). Hours spent verifying refund claims should be noted in the "General Audit Comments" section of the audit report as set forth by the policy in AM section 0206.48, *Overpayment Comments*.

Requests for extensions to provide supporting documentation should follow the policy set forth in AM section 0401.05, *Waiver of Credit Interest Policy*. There may be instances where it is appropriate to obtain a waiver of credit interest, however, the taxpayer is entitled to an offset of debit interest on the original audit liability when the claim is processed in a reaudit. If the taxpayer cannot provide supporting documentation within the timeframes set forth in AM section 0401.05, the claim should be denied.

In cases where a claim for refund is filed after the completion of the audit and is therefore not addressed in the original AWPs, and the liability is in petition status, adjustments shall be included as part of the reaudit when warranted. Claims for refund within the audit period filed within six months of the date the determination became final are open to a credit offset adjustment and shall be processed as part of a reaudit in accordance with AM section 0703.05.

For more detailed information regarding credit offset adjustments, refer to AM section 0434.00, *Credit Offsets*.

MANAGED AUDIT PROGRAM 0435.00

MANAGED AUDIT PROGRAM – GENERAL 0435.05

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

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

ELIGIBLE ACCOUNTS 0435.10

It is extremely important that the auditor conduct a thorough review of the taxpayer's operations prior to recommending participation in the Managed Audit Program (MAP). Taxpayers should not be considered a candidate for the MAP if their business operations consist of transactions which require an in-depth knowledge of the law.

ELIGIBLE ACCOUNTS (CONT.) 0435.10

While it is the auditor's responsibility to determine whether a taxpayer is eligible to participate in a managed audit, a taxpayer may initiate the review process by requesting a managed audit be conducted. For example, taxpayers seeking a tax clearance or who have been notified of an audit may wish to conduct a managed audit to expedite the clearance or routine audit process. The auditor should consider all reasonable requests for participation, keeping in mind our primary goal is the cost savings in audit hours that can be used to perform other productive audits. Accordingly, interested taxpayers should submit their request for participation to the appropriate Audit Principal or Administrator. In that application, the taxpayer is required to clearly explain how they meet the statutory requirements of the appropriate Revenue and Taxation Code (R&TC) section.

- Alcoholic Beverage Tax (section 32458)
- Cigarette and Tobacco Products Tax (section 30457)
- Diesel Fuel Tax (section 60611), excluding Licensees registered under the International Fuel Tax Agreement (IFTA)
- Emergency Telephone Users Surcharge (section 41133)
- Energy Resources Surcharge (section 40177)
- Fee Collection Procedures (section 55306)
- Hazardous Substances Tax (section 43507)
- Integrated Waste Management Fee (section 45855.6)
- Motor Vehicle Fuel Tax (section 8258)
- Oil Spill Response Prevention and Administration Fees (section 46607)
- Sales and Use Tax (section 7076)
- Underground Storage Tank Maintenance Fee (section 50155.6)
- Use Fuel Tax (section 9259)

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

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

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

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

Although eligibility provisions contain some restrictive language, this should be balanced with the taxpayer's and/or representative's level of sophistication in understanding and dealing with any issues that may arise. Any inquiries regarding the eligibility of an account for the MAP should be sent by the Audit Principal or Administrator to the Assistant Deputy Director – Audit, Field Operations Division or the Chief of the Audit and Carrier Bureau, as appropriate.

APPLICATION OF INTEREST AND PENALTIES 0435.15

(a) Interest

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

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

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

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

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

(b) Penalties

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

(c) Petitions for Redetermination or Claims for Refund

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

AUDIT PROCEDURE 0435.20

The Managed Audit Program (MAP) can be a valuable tool in streamlining the audit process. It is designed to reduce the time it takes to complete an audit and minimize the burden on taxpayers. When planning the audit, supervisors and auditors should evaluate whether the taxpayer is eligible for the use of a MAP. This evaluation should be conducted whether or not the taxpayer has already requested the use of a MAP.

It is primarily the responsibility of the auditor to determine whether a taxpayer should be considered for the MAP. However, it is the auditor's immediate supervisor who is responsible for approval of the auditor's recommendation. If the taxpayer is eligible for use of a MAP, the auditor should discuss the MAP with the taxpayer as soon as possible rather than wait for the taxpayer to request using a MAP. The date of the discussion with the taxpayer and the taxpayer's response should be documented in the system in CRM Notes. A decision that the taxpayer is not eligible should also be explained and documented in the system in CRM Notes.

(a) Preliminary Review

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

The auditor may also consider the use of a Computer Audit Specialist to improve audit efficiency (reduce audit hours) if the account meets the criteria outlined in section 1301.25.

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

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

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

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

(b) Managed Audit Program Participation Agreement

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

- Taxpayer's name and account number;
- Audit period;
- A reasonable time period (generally within 90 days) the taxpayer is allowed to complete the work. However, the auditor should use his or her discretion to accommodate larger business operations;
- Deadlines to complete the review of each transaction type or record, e.g., claimed deductions, purchases of consumable supplies, etc.;

Information on the types of transactions and records to be reviewed; and

- The method for review and the periods for the records to be reviewed.
- This agreement will then be signed and dated by the taxpayer and the District Principal The MAP participation agreement will then be signed and dated by the taxpayer and the District Principal Auditor. A copy of the signed agreement will be provided to the taxpayer. The original signed agreement and a copy must be attached to the audit report (see AM section 0213.03).

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

- The taxpayer has failed to complete the managed audit by the due date in accordance with the provisions in this agreement;
- The apparent nature and/or complexity of the taxpayer's operations and/or transactions require greater levels of review, research or verification than was originally anticipated;
- The taxpayer has refused to cooperate with the Board during the verification process described in paragraph 4 of the agreement or has refused to cooperate with the Board if it audits any transactions pursuant to paragraph 5 of the agreement;
- Any penalties for negligence or fraud are imposed during the audit period under RTC sections 6484, 6485, 6485.1, or 6514.1;
- There is jeopardy of collection under 6536; or
- The payment of the liabilities and interest was not made within the time period specified by the Board.

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

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

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

Before the CDTFA voids a MAP participation agreement, a summary of the specific circumstances of the case and reasons for voiding the agreement must be provided to the Deputy Director, FOD. Upon approval by the Deputy Director, FOD, the District Principal Auditor will send the taxpayer a written notification of the termination of the MAP participation agreement, and the reasons for such termination. The front of the audit report should continue to be marked as MAP for program evaluation purposes with an explanation for the termination shown on the back of the audit report. Also, the AUD MC screen in IRIS should have the flag set to "N" for managed audit, otherwise, the reduction in the interest rate will be triggered.

Participation in the MAP is voluntary on the part of the taxpayer. None of the above actions by the taxpayer should have a negative impact on how the audit is completed or the scope of the audit verification to be performed by the auditor. The only impact will be that the taxpayer will not receive the benefit of the one-half interest rate should the audit result in a tax liability.

(c) Verification of Taxpayer's Examination

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

(d) Audit Comments

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

(e) Audit Report

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

The Audit Determination and Refund Section will ensure that the interest calculation is correct for all managed audits and that the "interest through date" is correct prior to billing. Once the audit report is approved for billing, a copy of the audit report and the MAP participation agreement will be made and forwarded to the Chief, Tax Policy Division with a copy to the Deputy Director, FOD for evaluation of the MAP.

ALTERNATIVE METHOD OF REPORTING USE TAX 0436.00

GENERAL 0436.01

Ex-tax purchases subject to use tax are ultimately the tax liability of the purchaser storing, using or otherwise consuming the property in this state. Similarly, ex-tax purchases subject to transactions and use tax (district tax) are ultimately the liability of the purchaser when purchased for use in a district imposing such a tax and thereafter used there.

The Alternative Method for Reporting Use Tax (AMRUT) Program is a process whereby a taxpayer can write to the State Board of Equalization (CDTFA) and propose a prospective use tax reporting method for qualified purchases subject to use tax (see AM section 0436.04, item B). The alternative reporting method replaces the usual method of reporting use tax on a transaction-by-transaction basis. The alternative reporting method will not allow a taxpayer to issue resale or exemption certificates to vendors solely for the purpose of directly reporting the use tax under the AMRUT Program. The taxpayer's proposal must address the following matters:

- The remittance of use tax directly to CDTFA on certain mutually agreed-upon categories of purchases.
- The application of a mutually agreed-upon taxable percentage to the taxpayer's total purchases for these categories to determine the tax.

If CDTFA concludes the proposed reporting method accurately reflects the taxpayer's use tax liability for the defined population, CDTFA will prepare a written response to the taxpayer approving (subject to certain conditions) the use of the proposed reporting method. This written correspondence is required for an approved AMRUT.

In general, audits of purchases covered by a CDTFA-approved reporting method will not ascertain whether or not tax was overpaid or underpaid on a transaction-by-transaction basis. Instead, the audit will determine whether or not the taxpayer complied with the criteria specified in the CDTFA-approved AMRUT. Audits of purchases outside the scope of the CDTFA-approved AMRUT, such as purchases of fixed assets, should be examined in accordance with procedures described in this manual.

ELIGIBILITY 0436.02

CDTFA encourages participation in AMRUT and will not restrict eligibility to any particular taxpayer, regardless of the size or type of business. In order to be eligible to participate in the program, the taxpayer must be registered with CDTFA to report sales and use tax, be in good standing, and maintain acceptable accounting records and internal controls in accordance with the provisions of Regulation 1698, *Records*. Taxpayers requesting approval must provide the necessary accounting records (including electronic data files) upon request in a timely manner.

Ideal candidates for this program include taxpayers who typically have large volumes of recurring purchases subject to use tax. The taxpayer's business and purchasing practices must be consistent.

AMRUT APPROVAL PROCESS 0436.03

The taxpayer initiates the request to participate in the AMRUT Program by submitting a written request to the District Principal Auditor (DPA) in the taxpayer's district of account. Requests must include:

- The taxpayer's name, address and seller's permit number,
- The period for which the request is being made,
- An assurance that the taxpayer's accounting records and internal controls are acceptable pursuant to the requirements of Regulation 1698, and
- Identification of any records that are maintained electronically.

CDTFA will only consider written requests for participation where the taxpayer is identified. Within 10 business days of receiving a request for participation, the district of account will send an acknowledgment letter to the taxpayer providing information about the program, outlining the implementation process and soliciting additional information, if needed. The taxpayer will be provided Form CDTFA-472, *Use of Sampling in Auditing*, to complete prior to beginning the taxable percentage calculation. Auditors will work with the taxpayer to determine the agreed-upon categories of purchases and the taxable reporting percentage. This process should be completed within 90 days after the taxpayer's accounting records are made available.

After completion of the taxable percentage calculation, the DPA will prepare a memo to the Supervisor, Audit and Information Section (AIS) containing the district of account's recommendation regarding the taxpayer's participation in AMRUT. The memo should include all details regarding the taxable percentage calculation and a copy of the completed Form CDTFA-472. The AIS Supervisor will review the materials and notify the DPA in writing of approval or denial of the taxpayer's participation in AMRUT. The DPA will then furnish a letter to the taxpayer, with a copy to the AIS Supervisor, approving or denying the taxpayer's request for participation in AMRUT. If approved, the letter to the taxpayer must also include all details regarding the AMRUT, such as the taxable percentage to be used, the purchases the taxable percentage applies to, and the time period AMRUT is effective (AM section 0436.05, *Term*). In addition, general information about the program, such as termination or the definition of a significant business change, must be provided to the taxpayer.

TAXABLE PERCENTAGE CALCULATION 0436.04

A. Base Period Selection

It is essential to select a mutually acceptable base period and scope of purchases covered by the proposed AMRUT. If currently under audit, the base period is typically the current audit period. However, the taxpayer and the auditor may select transactions occurring over some other period if necessary. At a minimum, 12 months of detailed accounting records, which include the most recent reporting period, should be used to calculate the taxable percentage. When this minimum is used, summary accounting records from the two preceding years must be provided for comparison purposes.

When selecting a base period, it is essential the tested purchases are representative of the taxpayer's normal purchasing activity and anticipated activity in future filing periods.

B. Taxable Percentage Calculation

The most important element of this reporting method is the calculation of the taxable percentage to be applied prospectively to purchases within the defined population. Under this method, the taxpayer will calculate (with auditor involvement) a taxable percentage to be applied to purchases from specific categories of transactions. Percentages are calculated as follows:

1. Determine which of the examined purchases in the base period are subject to use tax.
2. Divide the resulting taxable purchases by total purchases in the base period.

The total purchases subject to use tax for the approved period is calculated by applying the taxable percentage to total purchases from the same specified categories of transactions.

The taxable percentage calculation may be based on statistical sampling, non-statistical sampling or a detailed review of the transactions in the base period. However, the taxpayer and the auditor must agree on the sampling plan and procedures used to calculate the taxable percentage.

The taxable percentage calculation and application are limited to qualified purchases. This excludes specific categories of transactions such as fixed asset acquisitions and other accounts or transactions the taxpayer or the auditor believes are atypical (e.g., resale inventory withdrawals, inter-company purchases, etc.) and should not be included in the defined population. Fixed asset acquisitions are excluded since these purchases generally are one-time transactions. Atypical purchases skew the taxable percentage calculation and negate the validity of the sample.

It may be necessary to calculate more than one taxable percentage to be applied to different categories of purchases. Computation of different percentages may be established by:

- Account number(s)
- Subsidiary
- Location
- Division
- Computer accounting system
- District tax
- Other criterion that makes business sense and produces a reliable and verifiable estimate of the taxpayer's use tax liability.

C. Sample Selection

To establish a prospective taxable percentage, a sample may be drawn from transactions that occurred in prior periods. Whenever sampling techniques are used, an estimate is made instead of using the actual result from a detailed review of the population. Therefore, the sample must be representative of the population. It is expected that the sample results will approximate the use tax currently being reported on a transaction-by-transaction basis for qualified purchases after considering CDTFA audit adjustments (if applicable).

The auditor must be involved in the sample selection process. Prior to beginning the process, the taxpayer will complete a preliminary Form CDTFA-472. Both the taxpayer and the auditor must agree to the sampling plan and then a final Form CDTFA-472 will be completed.

If statistical sampling techniques are used, the sample results will be evaluated to determine how accurately the sample reflects the population. Statistical sampling techniques must be in accordance with AM Chapter 13, *Statistical Sampling*.

RTC section 6406 credits and atypical transactions encountered during base period testing will be reviewed and evaluated by the auditor on a transaction-by-transaction basis.

D. Electronic Records

Generally, taxpayers that wish to report use tax using AMRUT will maintain and provide access to their accounting records in electronic format. The auditor will be involved in the analysis of these records during the review and approval process. The taxpayer will be required to provide to the auditor a data download of the necessary electronic accounting records, including control totals, in a format prescribed by the auditor.

E. Disputed Transactions

CDTFA will not issue a letter approving a taxpayer's proposal if the taxpayer and the auditor cannot agree on a sampling plan or resolve disputes regarding individual sample transactions.

TERM 0436.05

The taxpayer will be notified of the specific period for which the applicable percentage may be relied upon. Generally, this will be a 36-month period corresponding with the taxpayer's reporting basis. This information will be included in the DPA's letter to the taxpayer outlining the specific details of the AMRUT.

RENEWAL 0436.06

CDTFA's approval to use AMRUT is not automatically renewable. CDTFA may approve an extension for subsequent time periods. CDTFA retains the right to audit the taxpayer's records to determine if the taxpayer's business practices or operations have changed.

Renewals or extensions will be handled in the same manner as initial requests for participation as provided in AM section 0436.03, *AMRUT Approval Process*. The taxpayer must initiate an extension or renewal request by submitting a written request to the DPA. At the discretion of the DPA, the auditor may recommend using the existing taxable percentage based on a review, to the extent deemed appropriate by the DPA, of the taxpayer's records or the auditor may calculate a new taxable percentage as provided in AM section 0436.04, Taxable Percentage Calculation. After determining the taxable percentage, the DPA will prepare a memo to the AIS Supervisor containing the auditor's recommendation regarding the taxpayer's continued participation in AMRUT and all details regarding the taxable percentage calculation. The AIS Supervisor will notify in writing the DPA of approval or denial of an extension in AMRUT for the taxpayer. The DPA will then furnish a letter to the taxpayer, with a copy to the AIS Supervisor, approving or denying the taxpayer's extension request to participate in AMRUT. The letter to the taxpayer must also include all details regarding the AMRUT, such as the taxable percentage to be used, the purchases the taxable percentage applies to, and the time period AMRUT is effective.

TERMINATION OR CANCELATION 0436.07

CDTFA may rescind its approval of the reporting method if the taxpayer fails to comply with any of the program's conditions. In addition, the written approval of the use tax reporting method is void if the taxpayer files a claim for refund for tax that had been reported based upon this reporting method.

Upon written notification to the taxpayer, the approved AMRUT is rescinded. The notification shall be effective as of a date specified by CDTFA. Accordingly, the approved AMRUT becomes invalid the first day of the subsequent quarterly filing period, but no less than thirty (30) days after the effective date of CDTFA's written notification.

At any time, the taxpayer may elect to discontinue reporting use tax based upon the approved AMRUT. The taxpayer must notify CDTFA in writing of the election to discontinue the alternative reporting method within the quarterly filing period of the election.

Once the AMRUT is rescinded, cancelled, voided, or discontinued the AMRUT can no longer be relied upon as advice that may qualify for relief under RTC section 6596 except to the extent that a transaction examined as part of the taxable percentage calculation is incorrectly classified as not being subject to use tax.

REVISED PERCENTAGES 0436.08

A. Notification Requirements

The taxpayer is responsible for monitoring and advising CDTFA of any activities that significantly change the facts and circumstances upon which CDTFA's previous approval of AMRUT was based. The taxpayer is required to notify CDTFA of significant changes including, but not limited to:

- Changes in accounting policy – changes that affect the distribution of use tax transactions in the accounts covered under the AMRUT that would significantly affect the agreed-upon percentage.
- Changes in purchasing practices – changes in purchasing activities that would significantly affect the agreed-upon percentage.
- Other significant business changes, as discussed in item B below.

Notification to CDTFA must be in writing and addressed to the DPA in the district of account within 90 days of the significant change. The taxpayer will be allowed a reasonable time in which to provide supporting documentation. A significant business change affecting the taxable percentage will terminate the approved AMRUT and the taxpayer will be required to request approval to use the revised taxable percentage. The taxpayer's request shall be subject to CDTFA's review and approval based on the new information. If the revised taxable percentage is approved, the letter discussed in AM section 0436.03 will be sent to the taxpayer. The revised taxable percentage will become effective commencing the first day of the quarterly filing period following CDTFA's approval.

If the taxpayer fails to report a significant business change within the specified period, the approved AMRUT may be rescinded and the taxpayer may be liable for any unreported use tax due from the first day of the quarterly filing period following the date of the significant business change.

The use of the revised taxable percentage without CDTFA's approval will not serve as basis for RTC section 6596 relief.

B. Significant Business Changes

This program does not relieve the taxpayer of his or her responsibility to report in accordance with changes in the California Sales and Use Tax Law and the accompanying regulations. Changes in laws may occur during the period when the approved AMRUT is in effect. During the period the approved AMRUT is in effect, the taxpayer is responsible for monitoring its purchasing practices and the California Sales and Use Tax Law to ascertain any changes that may significantly affect the taxable percentage.

Events which may result in a significant business change that are likely to affect the taxable percentage include, but are not limited to the following:

- Change in the product line,
- Change in purchasing procedures (for example, implementation of cost containment programs),
- Merger or acquisition,
- Discontinuation or start up of manufacturing or support facilities,
- Change in application of tax due to statutory change, regulatory change or a change in the application of the law due to a court decision, or
- Change in the financial or accounting system (for example, utilization of a different software program to record purchases).

When the taxpayer makes a change in business practices, procedures or operations, including but not limited to those described above, the taxpayer must determine whether the event(s) results in a significant change to the agreed-upon percentage. For purposes of audit, the taxpayer should retain the documentation he or she used to determine whether the event is significant.

If a change in business practices, procedures or operations occurs, the following thresholds will be used to determine whether the event is significant. A significant business change has occurred when, over a 12-month period:

1. An increase in purchases subject to use tax for the agreed-upon categories of purchases results in unreported purchases subject to use tax of $100,000 or more in measure; or

2. For this same period, the taxable percentage calculation used to determine use tax reporting increases by 10 percent or more from the previously agreed-upon taxable percentage.

For example, if the agreed-upon taxable percentage was determined to be 10 percent, and thereafter, over a 12-month period, based upon a change in vendors from an in-state vendor to an unregistered out-of-state vendor, the actual taxable percentage increased to 12 percent, this would be regarded as a significant business change that requires the taxpayer to notify CDTFA of the change. This change represents a 20 percent increase in the taxable percentage (2 percentage points difference between actual and agreed-upon taxable percentages divided by the agreed-upon taxable percentage).

If the taxpayer utilizes multiple taxable percentages for reporting, each taxable percentage should be examined individually to determine if a significant business change has occurred. Therefore, changes in business operations may result in a significant business change occurring for one or more of the taxable percentages, but not for all taxable percentages. The taxpayer may continue to utilize approved taxable percentages that were not affected by a significant business change requiring CDTFA notification.

Although the thresholds provided for determining whether a change is significant require the use of 12 months of purchases, this does not allow the taxpayer to wait 12 months after the event occurred that is deemed a significant business change before notifying CDTFA. The time period to notify CDTFA remains within 90 days of a significant business change. The thresholds are provided as a means of quantifying whether an event is significant.

The taxpayer is required to retain documentation he or she used at the time of the business change to determine whether the event is significant. This may require the taxpayer to look forward or project how the change would impact the taxable percentage over the next 12 months. If this documentation supports the fact that the change qualifies as a significant business change, the taxpayer must provide notification to the CDTFA within 90 days of the event. If this documentation supports the fact that the change was not expected to be significant, and later found to be significant, the taxpayer should notify CDTFA within 90 days of this discovery.

If the taxpayer anticipates that the reporting percentage is likely to fluctuate and is not likely to remain stable, the business may not be an appropriate candidate for AMRUT.

POST REVIEW AND EVALUATION 0436.09

The district office may choose to review the records any time during the term of the AMRUT to monitor the integrity of the program or in conjunction with a sales and use tax audit.

CDTFA will verify the taxpayer is in compliance with the AMRUT. This includes verifying the mechanical accuracy and appropriateness of accounting procedures for all applicable accounts within the defined population.

The taxpayer's records will be reviewed to determine if there has been an unreported change in business practices or operations during the applicable period. The review will determine if any unreported business changes have a significant impact on the agreed-upon percentage. This may include a comparison of vendors from the original test with the list of current vendors to determine if there has been a significant change in the in-state versus out-of-state vendor distribution.

CDTFA will perform a detailed (transaction-by-transaction) test of purchases if it has previously established that one or more events have taken place that may have resulted in a significant business change. Prior to initiating a detailed test of purchases, the DPA will review the preliminary analysis that determined a significant business change has occurred.

APPLICATION OF TAX TO SPECIFIC TRANSACTIONS 0437.00

FOOD SALES AT MOVIE THEATERS 0437.05

GENERAL

In audits of movie theaters, the admission policy of the theater may affect the application of tax to the sale of food products at the theater. Sales and Use Tax Regulation 1603, *Taxable Sales of Food Products*, provides guidance to establishments that make taxable sales of food products.

Regulation 1603, subdivision (d), *Places Where Admission is Charged*, provides in pertinent part that:

> Tax applies to sales of food products when sold within, and for consumption within, a place the entrance to which is subject to an admission charge, during the period when the sales are made, except for national and state parks and monuments, and marinas, campgrounds, and recreational vehicle parks.

Regulation 1603, subdivision (f) *Food For Consumption at Facilities Provided* by the Retailer, provides in pertinent part that:

> Tax applies to sales of sandwiches, ice cream, and other foods sold in a form for consumption at tables, chairs, or counters or from trays, glasses, dishes, or other tableware provided by the retailer or by a person with whom the retailer contracts to furnish, prepare, or serve food products to others.

APPLICATION OF TAX

Movie theaters that require customers to first purchase tickets before entering the area where food is served must report tax on all sales of food and beverages, including popcorn, in accordance with Regulation 1603(d).

In audits of movie theaters, the issue of an "open lobby" policy must be considered. A theater with an "open lobby" is one where a customer may enter the theater lobby area for other purposes, such as playing video games or purchasing food or drink, without requiring the purchase of a theater ticket.

In determining whether or not a movie theater has an "open lobby" policy, auditors should consult with theater management and review written policies, if available, before making the determination. Since customers who patronize movie theaters without the purchase of a ticket to view a movie may be infrequent, auditors should rely on more than the actions of an individual employee in the theater lobby to determine the theater's admission policy and if the theater has an "open lobby." Just because an individual employee may require a ticket to enter the theater does not conclusively mean the theater does not have an "open lobby." Thus, auditors cannot rely solely upon the use of standard observation tests to determine whether or not a ticket is required to enter the theater lobby.

If a movie theater has an "open lobby" policy, the next consideration regarding whether or not tax applies to sales of food is whether or not the movie theater provides facilities for the consumption of the food sold. For example, some theaters may provide tables and chairs for consumption of food and beverages near an arcade or otherwise within the lobby area. As set forth above, under Regulation 1603, subdivision (f), all food and beverages sold for consumption at such facilities are subject to tax. Many theaters provide benches for general seating. These benches do not constitute facilities for consumption of food and beverages.

Additionally, under Regulation 1603, subdivision (f), theater seats do not constitute facilities intended for consumption of food and beverage. Even if the movie theater provides facilities for consumption within the lobby area, sales of cold food "to go," such as for consumption in the theater, are not taxable.

Thus, when auditing a movie theater, the following applies:

1. Sales of all food items are subject to tax in theaters that do **not** have an open lobby policy (Regulation 1603(d)).
2. In theaters with an "open lobby" policy,
   - The theater does not constitute a place where admission is charged (Regulation 1603(d)).
   - Sales of cold food items are not subject to tax unless the items are for consumption at facilities specifically provided for consumption (i.e., tables and chairs).
   - Seats in the viewing area of a movie theater are **not** considered facilities for consumption of food and beverages. (Regulation 1603(f)).
   - Where tables and chairs are furnished for eating, the theater has the option to elect to separately account and not remit tax on sales of cold food "to go" per Regulation 1603(c)(1)(A).

APPLICATION OF TAX TO MULTI-USE CONTAINERS 0437.10

This section clarifies the application of tax to returnable pallets used to hold both food products and other non-food products, as well as containers used to bake and ship bread. For information on how tax generally applies to returnable or non-returnable containers in other situations, see Regulation 1589, *Containers and Labels.*

FOOD PRODUCT CONTAINERS

Revenue and Taxation Code section 6364(d) (see also Regulation 1589(b)(1)(E)), provides a sales and use tax exemption for the sale or purchase of all containers when sold or leased without the contents to persons who place food products for human consumption in the containers for shipment, provided the food products will be sold. The exemption applies without regard to whether the food products are sold in the same container or not, or whether the food products are remanufactured or repackaged prior to their sale.

PALLETS

Under Regulation 1589(a), pallets, among other items, are included in the definition of "containers."

Returnable Pallets for Other than Food Products

Tax applies to the initial sale of returnable pallets whereby the pallets are returned for reuse. Tax does not apply to the sale of returnable pallets when the pallets are sold with the contents in connection with the retail sale of the contents, or when resold for re-placement of the contents on the pallets.

> *For example*, a taxpayer purchases pallets to ship its product to its customer. Tax applies to the sale of the pallets to the taxpayer. When the taxpayer sells its product to its customer and requires the customer to return the pallet to the taxpayer, any charge (deposit) for the return of the pallet by the taxpayer's customer is not taxable, whether or not the charge (deposit) is forfeited.

Returnable Pallets Used For Food Products for Human Consumption

When pallets are sold as containers for the purpose of holding food products for human consumption, the sale or purchase of the pallets is exempt from tax.

When tangible personal property, other than food products for human consumption, is placed in or on the pallets, the use of the pallets is considered to be outside the scope of the exemption and any such sales or purchases of those pallets is subject to tax. The exemption set forth in section 6364(d) does not apply to sales of pallets that are used to hold both food products for human consumption and other tangible personal property (non-food products). Therefore, when pallets are used to hold both food and non-food products the sales of pallets are subject to tax. Taxpayers may not exempt a portion of the pallet sales based upon a percentage of use.

ALUMINUM BREAD PANS

Regulation 1589(a), defines "containers" to mean the articles in or on which tangible personal property is placed for shipment and delivery, such as wrapping materials, bags, cans, twines, gummed tapes, barrels, boxes, bottles, drums, carboys, cartons, sacks, pallets, and materials from which such containers are manufactured.

When aluminum bread pans are used to hold food products, i.e., bread, such pans are considered "containers" as defined in Regulation 1589(a). The use of the containers for baking bread does not supersede the use of the containers for shipment of the food products for human consumption.

> *For example*, if the aluminum bread pans are shipped holding raw bread dough via refrigerated trucks and then the bread is baked after delivery, the containers qualify for the exemption and may be purchased ex-tax.
>
> Similarly, baking the bread in the aluminum bread pans prior to shipment does not preclude the use of the aluminum bread pans as containers.

TAXABILITY OF MEAL REPLACEMENT PRODUCTS 0437.15

This section clarifies the interpretation of Revenue and Taxation Code (RTC) sections 6359 and 6369 (see also Regulation 1602, *Food Products,* and Regulation 1591, *Medicines and Medical Devices*) as they apply to meal replacement products.

GENERAL

The exemption for certain sales of meal replacement products is addressed in Regulation 1602(a)(4) and Regulation 1591. Regulation 1602(a)(4), provides that if the meal replacement product sold is a complete dietary food providing the user with the appropriate amounts of vitamins, proteins, and minerals including the minimal count of at least 900 calories per day, the product may be claimed as an exempt food product. If the item does not qualify as an exempt food product, staff may look to whether the product qualifies as an exempt medicine. If the requirements under either Regulation 1602(a)(4) or Regulation 1591 are met, the meal replacement products are exempt from tax.

COMPLETE DIETARY FOODS

Regulation 1602(a)(4), in part, provides that tax does not apply to products which are complete dietary foods and the complete dietary food must provide the user with the following daily minimums:

1. 70 grams of high quality protein
2. 900 calories
3. Minimum daily requirements as established by the regulations of the Federal Food and Drug Administration of the following vitamins: A, B1, C, D, Riboflavin, and Niacin, or Niacinamide; and the following minerals: Calcium, Phosphorus, Iron, and Iodine.

A critical element of the example of a complete dietary food is that the food item contains at least 900 calories per day if taken (consumed) in the recommended daily dosage (e.g. 1 can per day at 900 calories or 3 cans per day at 300 calories each). As provided in Regulation 1602, a product with fewer than 900 calories per day by itself cannot qualify as a complete dietary food.

To determine whether the product being examined is a complete dietary food for purposes of Regulation 1602(a)(4), the daily nutritional content offered by the product is determined by multiplying the nutritional components of a single serving by the number of servings recommended per day on the label. If no such recommendation is noted, a determination will be based on three servings.

Meal Replacement Products May Qualify as Exempt Medicines

RTC section 6369 and Regulation 1591 provide that the gross receipts from the sale or use of medicines furnished by a licensed physician to his or her own patient for treatment of the patient are specifically exempt from taxation. Also, the gross receipts from the sale or use of medicines furnished by a "health facility" for treatment of any person pursuant to the order of a licensed physician are specifically exempt from tax. A "health facility" is defined in Regulation 1591(a)(4).

Meal replacement products are considered medicines when furnished by a physician to his or her patient as part of a medically supervised weight loss or gain program. When a physician furnishes to his or her patient meal replacements as part of a medically supervised weight loss or gain program, the sale of the meal replacement products are exempt from tax under RTC section 6369 and Regulation 1591.

RECORDS

Retailers making exempt sales of food products must maintain proper documentation to support the exemption. Pursuant to Regulation 1591(g)(1), any deduction on account of sales of medicines shall be supported by appropriate records which include, but is not limited to: the name of the purchaser, name of doctor or health facility, date of sale, item sold, and the sales price.

MOTION PICTURE INDUSTRY - RELEASE PRINTS 0437.20

GENERAL

Generally, release prints first exhibited in California are subject to either the sales or use tax. This section provides guidance on the application of tax to release prints first exhibited outside the State of California and is intended to apply to the motion picture industry. Due to the unique nature of transactions pertaining to the motion picture industry, this section applies exclusively to issues pertaining to release prints. See Regulation 1529, *Motion Pictures*, subdivision (d)(11) for a specific definition of "release prints."

RELEASE PRINTS FIRST EXHIBITED OUTSIDE OF CALIFORNIA

Regulation 1620, *Interstate and Foreign Commerce*, sets forth the conditions which determine whether merchandise brought into this state is subject to sales tax or use tax. As provided in Regulation 1620, subdivision (b)(3), it is presumed that property used outside the state for a period less than 90 days has a continued useful life, hence the deference to the primary use of the property for the following six-month period to determine the proper application of tax.

Release prints first exhibited outside of California are rarely exhibited for more than 90 days. Due to their limited physical life, a release print does not possess a useful life in excess of 90 days. Since release prints are unable to sufficiently meet the 90 day test criteria if returned to California at the end of its useful life, the entry or reentry of the release print does not automatically render the property subject to use tax. Accordingly, release prints cannot be deemed for use in California merely because they enter or reenter the state within 90 days.

After initial exhibition out-of-state and entry or reentry into California, release prints are often destroyed then shipped out-of-state for recycling; or refurbished for subsequent release into secondary markets. In either scenario, the first functional use via the initial out-of-state exhibition establishes that the release print was purchased for use outside the state and neither the sales nor use tax applies in California. As such, it is not the purchaser's intent to "use" the release prints in California, since their use outside the state generally renders them unfit for further use as release prints upon return to California. Thus, release prints which are initially exhibited outside of California are not deemed purchased for use in California.

RELEASE PRINTS PURCHASED FROM OUT-OF-STATE LABORATORY

In situations where a studio orders a release print from a laboratory that produces the release print and delivers it either directly to an out-of-state theater or a California based service company (who subsequently delivers the release prints to theaters outside California), the application of tax differs depending upon whether the laboratory is located in California or out of state.

The California service company, sometimes referred to as a “depot” by the industry, performs services which may include:

- Transportation of prints from the film laboratory to and from distribution centers, theaters, film warehouses, and salvage facilities.
- Total quality management to assure the highest print quality is delivered to the theaters.
- Complete inventory management from the time the print leaves the film laboratory to the time the print is destroyed.
- Integrated information systems including order entry, print control and tracking, defective print reports, and other management reports.
- Customer service to interface with exhibitors.
- Print rejuvenation services including inspection and cleaning.
- Logistics management for all matters related to shipment, delivery, inspection, retrieval, and storage of prints.
- Storage of used prints.
- Security control procedures to minimize potential for piracy, theft, or other loss of prints.

Tax does not apply to any release prints delivered to the California service company provided the release print is first exhibited out-of-state. The activities associated with the services identified above do not render the tax applicable in cases where the release print is first exhibited outside the State of California.

Upon return to California, the retention and subsequent “destruction” of the release print, including “de-reeling” and “chopping” of the release print for packaging, even when done to protect the intellectual interest of the release print, will not make the release print taxable in cases where the release print is first exhibited outside the State of California.

When refurbishing prints for subsequent release into secondary markets, it is common for portions of release prints to be spliced and combined to make copies suitable for distribution. This activity may include combining portions of release prints that were first distributed in California, and thus originally taxed with release prints which may have been first distributed outside the State of California. For the purpose of assessing tax on the refurbished release print, it will be presumed that a refurbished release print is tax paid as long as the percentage of all release prints distributed in the secondary market in California does not exceed the percentage of all release prints originally first exhibited in California. As long as this criteria is met, the subsequent distribution of refurbished release prints into the secondary market is exempt from tax. In cases where the release print is originally first exhibited outside the State of California, tax does not apply regardless of the fact that refurbishing of the release print is subsequently done in California.

However, if there is a sale of the refurbished release print, tax will apply to refurbished release prints first distributed in California.

RELEASE PRINTS PURCHASED FROM A CALIFORNIA LABORATORY

When a California laboratory delivers release prints to theaters for first exhibition inside California, such prints are generally subject to sales tax. However, delivery by the laboratory or California service company to an out-of-state theater for first exhibition is not subject to tax provided the release print is first exhibited out-of-state.

There are situations where a laboratory may deliver release prints to a California service company for subsequent delivery to theaters outside California. In cases where the California service company does in fact deliver the prints outside California via common carrier, the transaction qualifies as a sale in interstate commerce. As previously discussed, release prints which are originally first exhibited outside of California are not deemed purchased for use in California. The activities associated with the services identified in the prior section do not render the tax applicable when the release print is first exhibited outside the State of California.

Upon return to California, the retention and subsequent "destruction" of the release print, including "de-reeling" and "chopping" of the release print for packaging, even when done to protect the intellectual interest of the release print, will not make the release print taxable in cases where the release print is first exhibited outside the State of California.

REPORTING

In many cases, there is adequate documentation available to track the movement of the release prints for the purpose of assessing sales tax. However, for administrative ease, we will permit the reporting of tax based upon the use of a pre-approved percentage of release prints first distributed in California in cases where it is in the best interest of both the taxpayer and the State.

If approved, the established percentage may be used for a period of time which must be identified in the request (up to a maximum of three years). Three years was permitted to allow the district to review subsequent requests in conjunction with the taxpayer's eligibility for audit. The use of an approved percentage reporting method will constitute a "safe harbor" from additional assessments for liabilities in excess of the amounts reported based upon the approved reporting method.

The use of a percentage reporting method must be requested by the taxpayer in writing with a detailed description of the calculation of the percentage and computation of the base to which it is to be applied. The District Principal Auditor will forward the request along with a recommendation for approval or denial with explanation to the Chief, Tax Policy Division. After a response is received from the Chief, Tax Policy Division, the District Principal Auditor will send an acknowledgement letter to the taxpayer outlining the terms of agreement (if approved) or an explanation of the denial.

REBATES AND INCENTIVES 0437.25

GENERAL

This section explains the application of tax to payments received by retailers from rebate, incentive, buy-down and other promotional programs (third-party rebates) offered by manufacturers, vendors, and other third parties to promote the sale of their products.

Retailers often engage in marketing and sales promotions in which they issue coupons or other indicia to their customers that entitle them to a reduction in their purchase amounts. Manufacturers, vendors and other third parties offer various programs that result in credits or payments made to retailers with respect to a retailer's taxable sale of products to a customer. Regulation 1671.1, *Discounts, Coupons, Rebates, and Other Incentives,* addresses this topic, provides definitions for terms used and includes several examples of when rebates and incentives are and are not included in gross receipts.

If the records of a retailer who participates in rebate and incentive program are lacking or incomplete, the Internal Revenue Service Form 1099-Misc (1099) may be used to determine the taxable portion of the retailer's income when the 1099 is issued by a third-party who entered into a rebate or incentive program with the retailer that required a specific price reduction. However, a 1099 does not always represent taxable rebate payments that satisfy the conditions of the regulation. The amounts could, in whole or part, represent payments for nontaxable display, advertising or other nontaxable promotional allowances, as well as rebate payments that satisfy one, but not all, of the conditions of the regulation. The 1099 may also contain specific coding that will assist in the determination of the portion of the 1099 income that is received under a rebate or incentive program requiring a price reduction, earned for providing display space or for advertising the third-party's products.

TAXABLE GROSS RECEIPTS

Third-party rebates are included in taxable gross receipts or the sales price of the sale when **all** of the following conditions are satisfied:

- The retailer is required to reduce the selling price of certain products in order to receive the third-party rebate,
- The rebate payment is certain (not contingent on other factors), and
- The rebate is for a like amount that reimburses the retailer for the amount of the price reduction, on a transaction-by-transaction basis.

That is, the rebate payment received as part of a promotional program (e.g., buy-down program) must be traceable to a specific sale of a particular product and reimburse the retailer for the specified amount of the required reduction in selling price. A rebate payment is considered certain when fulfillment of the requirements of the contract between the retailer and the third party are within the control of the retailer at the time of the underlying retail sale (e.g., requiring the retailer to set up promotional signage in order to get the rebate).

There are also promotional programs and marketing strategies that do not require a reduction of the selling price of products by the retailer. Others that require a price reduction tie the rebate payments to the retailer's wholesale purchases and not their sales of the product at the reduced price. In any case in which the promotional price reduction is not required by a third-party or where the rebate revenue is not based on retail sales on a transaction-by-transaction basis, the revenue is not included in taxable gross receipts.

Some promotional programs (e.g. graduated rebate agreements) may require the retailer to sell a certain quantity of product at a specified reduced price for a set period to receive a wholesale price reduction or, in some cases, reimbursement for all, or a portion of the reduced selling price. Multiple thresholds, with an increase in rebate revenue for each threshold exceeded, may exist. This means the total rebate payment the retailer receives is not certain at the time of the retail sale. When the receipt of rebate payments or a portion of them are contingent and uncertain at the time of the retail sale of the specified products, the portion that is contingent and uncertain is not subject to tax. Regulation 1671.1, subdivision (d)(2)(D) provides an example of this situation.

Advertising and Display Allowances

Additional income received by retailers for the display or advertising of the third-party products is not included in taxable gross receipts. Display payments are earned by providing the display or shelf space, not by making retail sales of taxable products on a transaction-by-transaction basis. Advertising allowances, which are a reimbursement for a retailer's advertisement of particular products, are not included in gross receipts.

Third-Parties

A third-party is defined in Regulation 1671.1, subdivision (c)(1)(C) as a person other than the retailer or their customer, such as a manufacturer or retailer's vendor. Therefore, rebate revenues received by the retailer from a retailer's vendor are subject to tax in the same manner as rebate revenues received from manufacturers and other parties that do not sell the promotional products directly to the retailers.

Rebuttable Presumption

Although it is generally understood that all gross receipts are subject to tax unless the contrary is established, Regulation 1671.1 subdivision (c)(3)(A), provides a rebuttable presumption that consideration received by a retailer from a third-party related to promotions for sales of specified products is subject to tax, until the contrary is established. This subdivision provides a non-exhaustive list of examples that illustrate how this presumption can be rebutted.

Subdivision (c)(3)(A) provides specific regulatory support to include rebate revenue in taxable gross receipts when the retailer does not provide the necessary records and documentation to establish otherwise. This does not mean, however, that the retailer should not be given the opportunity to establish that such revenue may represent a purchase discount, advertising allowance, or some other nontaxable allowance. The presumption does not relieve staff of its responsibility to ensure that the retailer is aware of the type of documentation that will generally rebut the presumption or providing support in obtaining such documentation when requested.

The burden of establishing the taxable nature of rebate payments is on the retailer. However, this should not be interpreted as relieving staff of their auditing responsibility. At times, it may be easier for the auditor to verify the taxable nature of the rebates or have access to resources a retailer may not have to make the determination. The rebuttable presumption should not deter audit staff from providing support when requested or warranted.

Disclosure to Customers

Regulation 1671.1, (c)(3)(A) provides specific regulatory support for the inclusion of rebate revenue in taxable gross receipts when the retailer does not provide the necessary records and documentation to establish otherwise. Subdivision (c)(3)(B) states that when a retailer collects sales tax reimbursement (or use tax when applicable) from its customer, the retailer must disclose to the customer the amount upon which tax is collected, including the amount of any taxable discounts, rebates, or incentives offered or paid to the retailer by third parties. The regulation discusses the ways a retailer may satisfy its disclosure requirement. Staff should verify that the amount of any taxable rebates upon which a retailer is collecting tax is disclosed to customers. If not, the retailer should be informed of the requirement. It is recommended that auditors note in the audit working papers that these disclosure requirements were discussed with the retailer.

DEAL-OF-THE-DAY INSTRUMENTS 0437.30

This AM section provides guidance on the application of tax to sales of tangible personal property when all or part of the consideration paid by the purchaser consists of a deal-of-the-day instrument (DDI). DDIs are offered for sale by third-party, Internet-based companies (for example, Groupon or LivingSocial) on their websites as "deals-of-the-day." The deal-of-the-day features a DDI that can be redeemed for merchandise or services at local or national retailers. Customers purchase the DDI on-line which allows them to purchase a set amount of products and/or services from the participating retailer.

DDIs can be broken down into two component parts, and depending on the retailer, different terms and conditions may apply to each of the two component parts. We refer to the two component parts of a DDI as the "paid value" and the "promotional value." The "paid value" is the advertised selling price of the DDI (i.e., the amount the customer pays for the DDI) as provided in the contract between the retailer and the DDI provider (third-party, Internet-based company). The amount the customer pays for the DDI is less than the advertised face value of the DDI. Therefore, the "promotional value" is the value in excess of the amount paid (i.e., the difference between the face value of the DDI and the paid value).

DDI General Terms and Conditions

The following terms and conditions are generally applicable to all deal-of-the-day transactions:

1. Retailers negotiate contracts with DDI providers to sell DDIs for a set price. The contract between the parties sets the price the customer pays for the DDI.
2. The contracts provide that the DDI provider receives a certain percentage or dollar amount of the proceeds from the sale of each DDI. The contracts or other materials clarify that the amount paid by the retailer to the DDI provider is compensation for the service of advertising and selling the DDI on behalf of the retailer, and/or that the DDI provider markets the DDI as an agent or other representative on the retailer's behalf.
3. Customers may purchase DDIs with cash or cash equivalents, and customers may also apply DDI "bucks" or other types of consideration (i.e., reward points, loyalty points, or friend referrals) toward the purchase of the DDI.
4. The terms and conditions of the DDI include specified limitations on the use of the DDI. For example, they may state the DDI cannot be combined with "any other coupons or promotions," or "not valid for" certain items, or the customer "must use in one visit" and/or "no cash back" for partial redemptions of the instrument.

5. An expiration date for the full value (i.e., paid value plus promotional value) of the DDI is printed on the face of the instrument (e.g. six months from the date of issuance). However, the paid value generally has a later expiration date, (e.g., one year from date of issuance of the DDI). As an example, using the above dates, a DDI with a full value of $50 purchased for $25 can be redeemed for its full value ($50) for six months, after which time it can be redeemed for only the paid value ($25) for one year following the date of issuance. After the paid value expires, the DDI has zero value.
6. Retailers do not provide the customer with gift certificates, cash or cash equivalents upon redemption of the DDI.
7. DDIs are a single-use instrument and lose all value after the first use.

Sale of the DDI to the Customer

The purchase of the DDI from a third-party, Internet-based company is not regarded as a sale of tangible personal property (merchandise) or a service. The DDI is merely evidence of an intangible right to receive tangible personal property or a service at a later date and thus does not result in a taxable transaction.

Application of Sales Tax Upon Redemption of the DDI

DDIs that meet the general terms and conditions detailed in this AM section are retailer coupons. The gross receipts subject to tax upon redemption of the retailer coupon (DDI) for tangible personal property includes:

1. The consideration paid by the customer for the DDI (i.e., the paid value); plus
2. Any additional cash, credit or other consideration paid to the retailer at the time the retailer rings up the taxable sales transaction.

There is no deduction from the measure of tax when consideration other than cash, such as DDI Bucks, was applied by the customer toward the purchase of the DDI.

In situations where one DDI is offered for taxable and non-taxable sales, the amount paid by the customer for the DDI must be allocated between the taxable and non-taxable charges.

Staff Guidelines

Auditors should be aware that retailers may not properly compute tax on sales of tangible personal property when the customer uses a DDI as all or part of their consideration for the purchase. In many instances retailers apply the DDI as a cash discount, gift certificate, gift card, etc., and do not include the amount the customer paid for the DDI in their taxable gross receipts. The auditor should examine the taxpayer's receipts from third-party, Internet-based companies (e.g., Groupon, LivingSocial) as a method of verification (e.g., date DDIs sold, amount of DDIs sold). Additionally, contracts between the retailer and the DDI provider should be reviewed to determine that the DDI general terms and conditions listed in this AM section are met and to identify the paid value of the DDIs sold by the DDI provider.

Examples of Customer Redeeming DDI:

Example 1:

A website deal-of-the-day offer is $105 toward the purchase of a custom frame at Joe's Framing. The purchase price of the DDI is $50. Customer A purchases the DDI using $40 in cash, plus $10 in the form of "DDI Bucks" previously earned by referring a friend. Customer A then redeems the DDI to purchase a custom frame for $120 (excluding tax). The amount subject to tax is $65, which equals the $50 amount paid for the DDI plus the additional $15 required to be paid by Customer A to purchase the custom picture frame ($120 sales price minus $105 DDI equals $15 additional consideration paid).

Example 2:

Customer B saw the same deal-of-the-day and also purchased the DDI for $50 using cash. However, Customer B redeemed the DDI to purchase a $100 custom frame. The amount subject to tax in this transaction is $50, which equals the amount paid for the DDI. In this transaction, Customer B's purchase did not exceed the full value ($105) of the DDI.

Example 3:

Customer C purchased the same DDI as above for $50, and quickly purchased a frame for $39.99, plus tax, and surrendered the DDI to Joe's Framing for the purchase. Joe's Framing does not refund any cash or store credit to Customer C. Even though the frame cost $39.99, the measure of tax is $50 because that is the total consideration paid by Customer C for the frame.

Example 4:

When two or more retailers enter into a joint venture to offer one single-use DDI for sale:

Best Hotels and Joe's Steakhouse join together to offer a single DDI for the total cost of $50. The DDI includes a hotel stay at a Best Hotel valued at up to $75 plus a meal valued up to $25 at Joe's Steakhouse. The amount paid by the customer ($50) must be allocated relative to the value of the tangible personal property sold and the non-taxable room rental. Since the parties allocated the stated value of the food as 25% of the stated value of the package deal ($25/$100 = 25%), then 25% (i.e., $12.50) of the total amount paid by the customer (i.e., $50) must be allocated to the taxable sale of the meal upon redemption of each single use DDI.

ALTERATIONS BY A TAILOR 0437.35

When tailors (that are not clothes cleaning or dyeing establishments) alter clothing, their charges for altering *new* clothing are considered to be for finalizing the creation of that new clothing and the charges are subject to sales or use tax. However, charges by a tailor to alter used clothing are *not* subject to tax.

Clothing is considered new if:

- The labels or tags are still attached;
- It has unfinished hems, cuffs or other parts; or
- It has not been previously worn by the customer (except to try on).

Examples of alterations to new clothing may include, but are not limited to:

- Shortening/lengthening sleeves or pants
- Modifying waist sizes
- Hemming
- Restyling the item
- Changing design
- Adding/removing material from the item

The charges a tailor makes for altering new clothing are taxable regardless of whether the charges are separately stated or included in the selling price of the clothing.

Clothing is considered used if:

- It has been previously worn by the customer; or
- It is in a state of disrepair (i.e., worn out or torn).

The charges for altering used clothing are generally not subject to tax when such alterations are performed to refit or repair the item to its intended use for which it was created or produced. Examples of alterations to used clothing may include, but are not limited to:

- Replacing a zipper or button(s);
- Mending or patching a hole; or
- Taking in (or letting out) seams for a better fit.

Charges for alterations such as lengthening a pair of pants or taking in a skirt's waist are also *not* subject to tax as long as the clothing is considered used.

QUALIFIED PURCHASER PROGRAM 0438.00

GENERAL 0438.01

Revenue and Taxation Code (RTC) section 6225, *Use Tax Registration*, requires a "Qualified Purchaser" to register with the California Department of Tax and Fee Administration (CDTFA) and report and pay use tax directly to the CDTFA. A qualified purchaser under RTC section 6225 is a person who meets all the following conditions:

- The person receives at least $100,000 in gross receipts from business operations per calendar year.
- The person is not required to hold a California seller's permit or certificate of registration for use tax.
- The person does not hold a use tax direct payment permit as described in RTC section 7051.3.
- The person is not otherwise registered with the CDTFA to report use tax.

Qualified purchasers are required to file annual use tax returns and make payments using the CDTFA's on-line filing system. Returns are due on or before April 15th for the preceding calendar year's use tax purchases (if the due date falls on a Saturday, Sunday, or legal holiday, returns are due the following business day).

AUDIT REFERRALS 0438.05

When compliance staff determines that additional use tax may be owed by the taxpayer, such accounts should be referred to the office of account for audit. The referral should include all pertinent information, for example, prior audit history, copies of any related correspondence, federal income tax information, like business analysis, etc.

Audit staff will audit the leads referred by compliance staff following general audit procedures as set forth in this manual. Audit staff should inform the Out-of-State Compliance unit via form CDTFA–1164, *Audit Memorandum of Possible Tax Liability* (see AM section 0408.18), when an auditor discovers a taxpayer is purchasing items subject to use tax from an unregistered out-of-state retailer.

Special Tax and Fee Programs

When a qualified purchaser is purchasing items from outside of California subject to a special tax and/or fee (for example the purchase of new televisions, computers, tires, cigarettes and tobacco products, etc.), the supervisor or designee should send an email notification to the "BTFD-PAB Referrals from FOD" mailbox. Special tax and fee staff will investigate the notification and refer such leads to the appropriate division for further investigation.

JOINT AUDITS 0439.00

GENERAL 0439.05

A tax/feepayer may request concurrent audits (joint audits) of all their Board of Equalization (CDTFA) accounts in different tax and fee programs when any one of their accounts is selected for an audit. The audit engagement letters advise tax/feepayers to contact their auditor before the initial audit appointment if they are interested in joint audits of their CDTFA accounts.

Tax/Feepayer Requests Joint Audit(s)

When a tax/feepayer requests a joint audit in response to either the sales and use tax (SUT) or special taxes and fees (STF) audit engagement letter, the auditor who sent the engagement letter must ask the tax/feepayer to provide a list of all their tax and fee accounts. The auditor must also discuss the tax/feepayer's request with his/her supervisor.

Both SUT and STF audit staff should be prepared to cooperatively perform audits of all of the tax/feepayer's accounts when a joint audit is requested. Auditors should verify the list of accounts provided by the tax/feepayer to ensure that it is complete. Auditors should not waive any audit as the tax/feepayer may be seeking advice and education from CDTFA on their multiple accounts. However, audits may result in a No Opinion Warranted (NOW) report.

If the account selected for audit is a SUT account, then the SUT audit supervisor will email the Administrator of the Audit Examination Branch (AEB); if the audit selected is a STF account, then the AEB audit supervisor will email the appropriate District Principal Auditor. When preparing the email, staff should provide the following information:

- The tax/feepayer's name,
- The tax/feepayer's contact information,
- The permit/account number of the selected account,
- The audit period of the selected account,
- The list of all accounts obtained from the tax/feepayer, and
- The contact information of the auditor(s) who will be working on the audit.

JOINT AUDIT GUIDELINES

A major goal of the joint audit is to minimize the impact that two or more simultaneous audits have on the tax/feepayer. Therefore, coordinating appointments and record/data requests between the audit teams is important. This section provides guidance on how to streamline the joint audit process.

Staff Preparation and Coordination

Participating auditors from each program area will coordinate and prepare for the joint audit as follows:

- Discuss possible areas under audit,
- Discuss types of records to obtain,
- Discuss auditing techniques and procedures,
- Discuss data verification techniques,
- Request assistance from a computer audit specialist (CAS), if necessary,
- Discuss and identify data fields required,
- Discuss difficulties likely to be encountered and how to overcome them,
- Identify the lead auditor,
- Create a comprehensive check list of documents to be obtained and procedures to be performed, and
- Develop a comprehensive document request letter.

Conducting the Joint Audit

Staff should follow these guidelines when conducting a joint audit:

- The lead auditor (as identified during staff preparation) is responsible for coordinating and scheduling the appointments for field work ensuring that the tax/feepayer and auditors from each program area are taken into consideration.
- Participating SUT and STF auditors attend the initial audit appointment.
- If a Computer Audit Specialist (CAS) is needed, the CAS from both program areas attends the initial audit appointment. Afterwards, a single CAS may be appointed to obtain data for all audited accounts. The goal is to eventually have a single CAS assist with audits of a tax/feepayer who has multiple accounts.
- The CAS refines, reorganizes, and provides the relevant data to each program's auditors.
- The SUT and STF auditors are responsible for the completion of their audits in accordance with their respective established policy and procedures. As such, there will be multiple audit reports.
- If the tax/feepayer agrees, a joint exit conference may be scheduled. However, auditors should not wait for the completion of the other program's audit(s) to reveal audit findings to the tax/feepayer.
- The CAS and auditors charge the time spent on their respective audits to the appropriate audit case. Staff allocates time to the appropriate case if time was spent working on multiple cases.
- Each program includes budgeted hours for each account audited as established by the auditors and their supervisors. Any hours in excess of budgeted audit hours require the approval of the program area's Principal Auditor or Administrator, and must be documented in the CDTFA-414-Z, *Assignment Contact History*.

REASSIGNMENT / TRANSFER OF AUDIT ASSIGNMENTS 0442.00

The completion of an audit assignment may require reassignment of the audit to another auditor within the district office or transfer of the audit to another district office. The transfer of an audit to another district office may be done with transfer of control, see AM section 0403.07, *Transferring an Audit to Another District* or without transfer of control, see AM section 0442.04, *Interdistrict Cooperative Audits.*

REASSIGNMENT OF AUDITS WITHIN AN OFFICE 0442.02

The reassignment of an audit to another auditor generally occurs when the auditor currently assigned to the audit is not able to complete the audit (e.g., departing auditor). The following procedures are intended to minimize the impact of audit reassignments to taxpayers, representatives, and the audit program.

Upon receipt of notice of an impending employee departure or extended absence, the supervisor and the DPA must immediately review all assignments in process with the departing auditor and assess the likelihood of the completion of the audit assignments.

In the case of an employee promotion or lateral transfer to another district, if the audit assignments cannot be completed prior to the auditor's proposed departure date and district management does not foresee the audits taking an extended period of time to complete, district management will request the auditor be permitted to complete existing assignments after the promotion or lateral transfer date (i.e., loaned back). Each audit assignment should be addressed on a case-by-case basis, as a loan back may not always be feasible. Care should be taken not to delay promotion dates for employees.

If the departing auditor is not able to complete the audit assignments prior to the departure date, the supervisor must immediately reassign the audits to another auditor, taking into account the complexity of the assignments. The departing auditor, the auditor receiving the reassigned audits (new auditor) and the supervisor must discuss the status of the audits, including audit procedures used, records examined, schedules prepared and audit findings to date.

Departing Auditor's Responsibilities

- For each reassigned audit, prepare verification comments discussing in detail the completed areas of the audit and the records or transactions that remain to be reviewed.
- Introduce the new auditor to the taxpayer and/or taxpayer's representative.
- Hold a discussion with the taxpayer and/or the taxpayer's representative regarding the status of the audit. Everyone involved should have a clear understanding of the completed areas of the audit and the tasks that remain to be performed.
- Assist the new auditor as needed.

Responsibility of the New Auditor

The new auditor is responsible for the timely and accurate completion of the reassigned audit and must address the remainder of the audit appropriately. The examinations already completed by the departing auditor are not to be repeated. If the new auditor identifies significant problems with the work completed by the departing auditor, the new auditor should bring them to the attention of the audit supervisor immediately.

Responsibilities of the Supervisor

When an auditor leaves without notice, the audit supervisor must:

- Review all audits to be reassigned.
- Timely reassign the audits and contact the respective taxpayers to explain the necessity of the reassignment.
- Accompany the new auditor to the taxpayer's location for the initial meeting and discussion.
- Make several subsequent field calls in the initial stages of the reassignment and/or hold meetings with the taxpayer and new auditor to ensure satisfactory progress is being made, discuss any problems that the new auditor may encounter, and give the taxpayer assurance of continuity and someone to contact if there is a problem.

If the departing auditor completes all audit assignments prior to the scheduled departure or promotion/transfer date, the auditor's remaining time must be augmented by miscellaneous audit activities such as minor investigations, preparing written responses to taxpayer inquiries, or assisting on other audits. The departing auditor must not be assigned new audits.

INTERDISTRICT COOPERATIVE AUDITS 0442.04

An audit transferred without transfer of control occurs in interdistrict cooperative audits where the controlling district office assigns a portion of an audit or a related audit to one or more cooperating district offices. In this case, the controlling district office consolidates the audit findings and transmits the completed audit to ADRS.

An interdistrict cooperative audit is an audit with participation by auditors from more than one district office. It occurs under the following conditions:

- A district office starts and audit and transfers that audit to another district office for completion.
- A portion of an audit or a related audit is assigned to another district office.

Where the taxpayer's or related account's records are located in more than one district office, the audit is coordinated by the controlling district office. Generally the controlling district office is in the best position to obtain information with regard to the overall functioning of the operations of the accounts involved. In most cases, the DOA is the controlling district.

RESPONSIBILITIES OF THE CONTROLLING OFFICE 0442.06

The controlling district office assigns a portion of an audit or a related audit to cooperating district offices, consolidates the findings and transmits the completed interdistrict cooperative audit to ADRS. In addition, the controlling district office is responsible for the following:

1. Audit Control moves the cooperative district's audit workpaper folder to the appropriate auditor's Go-Back folder and notifies the auditor and supervisor that the cooperative audit workpaper folder is ready.
2. General review to verify that the cooperating district offices followed the procedures outlined and made their respective portion of the audit in a consistent and uniform manner.
3. Completion of the final Form CDTFA-204, *Interdistrict Cooperative Audit — Audit Verification*.
4. Conducting an exit conference to discuss consolidated audit findings.
5. Transmittal of the completed audit to ADRS.

Instructions to cooperating district offices should contain sufficient detail to ensure all phases of an audit are handled uniformly and for the same audit period. The anticipated degree of difficulty or complexity of an audit must be taken into account when providing cooperating district offices such instructions.

Assignments to cooperating district offices are electronically transmitted using Form CDTFA-204. Form CDTFA-204 should include specific instructions, including the following information:

1. A brief description of the taxpayer's operations.
2. The name and phone number of the person to be contacted at the taxpayer's office.
3. Audit procedures that have been or will be performed by the controlling or cooperating district offices.
4. Specific verification instructions, such as test periods. The cooperating district office should follow these instructions unless there is a compelling reason why this cannot be done. When the cooperating district office finds that any of the instructions are not appropriate, it should discuss alternatives with the controlling district office.
5. Informative matter that may pertain to unusual transactions, such as areas of potential error. This may include information on the taxability of fixtures and equipment when the audit is a close-out, selling prices, type of clientele, etc.
6. Information pertaining to Form CDTFA-122, Waiver of limitation.

RESPONSIBILITIES OF THE COOPERATING OFFICE 0442.09

A cooperating district office will give priority to requests from a controlling district. It must follow the specific instructions as expeditiously as possible. Any significant deviations must be discussed with the cooperating district. In addition, the cooperating district office is responsible for the following:

1. Discussion of the audit findings with the local representative of the taxpayer, with electronic copies of AWPs provided to the representative.
2. Initiating the email approval chain in Outlook when the cooperative audit is complete. (See Chapter 2, section 0213.06 for instructions).
3. Review of the work assigned to and completed by the cooperating district office. It is the responsibility of the cooperating district office reviewer to ensure that the partial audit is accurate and complete in the same manner as a completed audit report. The reviewer should also ascertain that the partial audit was completed as instructed by the controlling district office.
4. Preparation of Form CDTFA-204 (include Auditor ID, Class, Name and hours).
5. After the audit is reviewed, placing the audit workpapers in a subfolder with the following name:
6. District Code_Case Id_Taxpayer Name_Coop AWPs
7. Placing the above subfolder in the controlling district's folder located within the *Transfer Documents to Other Districts* folder located on the J:\drive.
8. E-mail notification to controlling district's Audit Control that the completed cooperative audit workpaper folder is ready to be retrieved.

Interdistrict AWPs must conform to procedures set forth in AM Chapter 3, *Audit Working Papers*. In addition, the AWPs must include a summary of differences established by each cooperating district office and the letters identifying the district office must precede the index on the AWPs.

GLOSSARY OF TERMS 0490.00

ADEQUATE

Fulfilling minimal requirements; satisfactory; acceptable; sufficient.

ANALYZE

To determine or examine the composition of an item, account or amount, usually by reference to its historical origin; particularly (auditing) to review and set forth in a working paper the details or classified summary of items in an account, obtained or substantiated, where necessary, by reference to sources, and accompanied by explanations of major items and by cross-references to related accounts. See SCAN; VERIFY; AUDIT.

APPROPRIATE

Suitable, desirable, reasonable, or necessary in a particular context; often used by accountants as signifying conformity with the value judgments implicit in current practices. See SIGNIFICANT; PROPER.

APPROXIMATE

Containing error; a quantity or verbal characterization which cannot validly be claimed to coincide in all respects with results which might be secured by more precise treatment.

ARITHMETIC MEAN

The result obtained by dividing the sum of two or more quantities by the number of items; usually denoted by a symbol such as Y. It is often intended as a representative quantity or as a measure of the central tendency of a group of items. See AVERAGE; MEAN.

AUDIT

An exploratory, critical review by an auditor of the underlying internal controls and accounting records of a business enterprise or other economic unit, precedent to the expression by him of the opinion of the propriety of its tax returns; often accompanied by a descriptive adjective or phrase indicating scope and purpose.

AVERAGE

1. Arithmetic mean.
2. Any central tendency of a series of quantities.

See ARITHMETIC MEAN; MEDIAN; MODE; WEIGHTED AVERAGE.

AVERAGE DEVIATION

A measure of the variation of a group of numerical data from a designated point; the arithmetic mean of the differences between each item and the arithmetic mean of the data or other selected point where the differences are added without regard to sign. Thus, the arithmetic mean of 5, 6, and 7 is $(5 + 6 + 7)/3 = 6$ and the average deviation, taken without regard to sign, is $(1 + 0 + 1) /3 = 2/3$. The smaller the result the more representative the data. See STANDARD DEVIATION: DISPERSION.

BREAK-EVEN POINT

1. The volume point at which revenues and costs are equal: a combination of sales and costs that will yield a no-profit, no-loss operation.
2. That point in the cost of a variable factor of production at which one or more alternatives are equally economical.

CENTRAL TENDENCY

The pattern displayed by a collection of interrelated data when plotted as coordinates.

CHECK

This is a loose term used in auditing to indicate examination or verification. As a verb, the word has no exact meaning and its use without a descriptive qualification is usually avoided. More descriptive words, such as verify, examine, or prove, are preferable. See TESTCHECK.

CLASSIFICATION

Grouping of transactions, entries, or accounts under a common head or heads; a list of such groupings.

CLERICAL ERROR

As applied to books of account, any incorrect entry or posting, especially when involving routine transactions; typical causes are wrong coding, faulty computation — as in an extension or footing, a failure to enter or post, a posting to a wrong account, and posting to the wrong side of an account.

COMPARE

To establish the correspondence or similarity of differently located items.

CONFIRM

A procedure used to obtain added proof through contracts or communications with independent sources to establish the correctness of situations or transactions; for example, establishing losses of merchandise from fire or theft.

CROSSCHECK

1. To add horizontally as well as vertically in order to assure the accuracy of totals.
2. To perform one operation, as in auditing, which will have the effect of aiding in determining the accuracy, property, or other characteristic of another operation.

DETAILED AUDIT

An examination of the books of account, or a portion thereof, whereby all or substantially all entries and transactions are reviewed and verified, as contrasted with an examination by means of tests or samples. See AUDIT; SAMPLE; TESTCHECK.

DISCREPANCY

Any observed difference between opinions or facts, often with the implication of an error or other impropriety in one or more of them.

DISPERSION

A measure of the variation of a group of numerical data from a central tendency, such as arithmetic mean, by determining the range of such data or their average deviation or standard deviation. See these terms.

EXAMINE

To probe records or inspect securities or other documents, procedures and scope, for the purpose of arriving at opinions of accuracy, propriety, sufficiency, and the like.

INTERNAL CONTROL

This consists of measures and methods employed within an organization to safeguard cash, inventories and other assets as well as to maintain the accuracy and proper functioning of the accounting system. This is of paramount importance in tax auditing since an efficient system of internal control can make the auditor's tests easier and more reliable.

JUDGMENT SAMPLE

A sample whose size and items composing it has been determined by someone who is familiar with the universe undergoing the test and capable of exercising informed and unbiased discretion in making the selection. Such samples are sometimes necessary when data are needed quickly or when interest is confirmed to only a part of the universe. They are usually less reliable for estimation and prediction purposes than are samples selected on a wholly random basis.

MARKDOWN

The reduction of an originally established selling price.

MARKDOWN CANCELLATION

The portion of original markon restored after a markdown has been made.

MARKON

The amount added to cost, in setting selling prices, to cover operating expenses and profit margin; the ratio to selling price of the amount added to cost, expressed as a percentage; also known as "markup" (see below).

MARKUP

1. The amount added to an established selling price for the purpose of determining a new and higher selling price; the percentage of markup is based on the previously established selling price.
2. The total amount by which established selling prices are increased during a given period in setting new selling prices.
3. = markon.

The Board usage of markup is synonymous with the meaning of markon and is the amount added to cost to obtain the sale price, and generally is referred to in terms of percentages. The percentage of markup is computed by dividing gross profit by cost of sales: G.P./C.G.S. = % of M.U. Businessmen often discuss gross profit in terms of percentages, but seldom discuss markup in these terms. Care should be exercised by auditors to make certain they are on common ground with the taxpayer when discussing gross profit and markup percentages.

MARKUP CANCELLATION

The elimination of a markup or such portion thereof as pertains to referent unsold merchandise. The removal of a previous addition to an established selling price. Markup cancellation is not to be confused with Board's usage of the "markup" definition. See MARKUP.

MARKUP FACTOR

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

MATERIALITY

1. The relative importance or relevance of any item included or omitted from a financial statement, or of any procedure or change in procedure that conceivably might effect such a statement.
2. The characteristic attaching to a statement, fact, or item whereby its disclosure or the method of giving it expression would be likely to influence the judgment of a reasonable person.
3. The relative importance of any audit coverage, such as the testing of certain accounts. The opinion can be reached only by a value judgment on the part of the auditor.

MEAN

A midpoint in an array of numbers. See ARITHMETIC MEAN.

MEDIAN

The central item in a list of numbers arrayed according to size; the value at which on equal number of items fall on either side in a list of numbers so arrayed; often represented by the symbol Md.

MODE

The item of most frequent occurrence in a group of numbers; often represented by the symbol Mo; the class of greatest frequency in a frequency distribution. See MEDIAN; ARITHMETIC MEAN; AVERAGE.

OBJECTIVE

Having a meaning or application apart from the investigator, the peculiarities of his experience, or of the environment, and substantiated or capable of being substantiated by the findings of independent investigators; said of a fact, judgment, or inference; as objective evidence. See SUBJECTIVE.

PRELIMINARY AUDIT

In an initial engagement, the investigation of the business and its accounting system and operating methods preceding the determination of the scope of the audit procedures to be employed.

PROBABILITY SAMPLE

A random sample with a computable sampling error. The computed error indicates the degree of representativeness (or lack thereof) which should be taken into consideration in interpreting the sample results.

PROCEDURAL AUDIT (or REVIEW)

The critical examination by an auditor of internal controls and other procedures employed within an organization, (a) looking at recommendations for their improvement whether by simplification, elaboration, or readaptation, or (b) as a regular feature of a periodic examination. Frequently, the review involves procedures other than accounting.

PROPER

In line with common practice; meeting specifications deemed fitting in the circumstances; ethical as well as legal.

PROVE

To verify or subject to a satisfactory test.

PROVE FOOTINGS

Footings are the sums obtained from vertical or horizontal additions, or both, and are used by the auditor to establish the accuracy of the totals. It usually is sufficient for tax audit purposes to verify the additions on most taxpayer's records to the closest $100. However, where the footings being verified are used to compute percentages based on tests, they should be verified to the closest dollar.

RANDOM

Arising from chance alone, in contrast with haphazard or systematic. Randomization requires careful planning to make certain that only chance elements are present, or that bias, if present or introduced, is known and measurable.

RANDOM NUMBERS

A set of numbers formed at random; generally arrayed in tabular form to assist in sample selection.

RANDOM SAMPLE

A sample in which all the elements have been drawn at random, or according to the laws of chance. The procedure by which the sample is constructed characterizes a random sample, rather than its specific content. See STRATIFIED SAMPLING; SYSTEMATIC SAMPLING; REPLICATION.

RANDOM VARIATION

A fluctuation resulting from chance alone.

RANGE

The difference between the largest and smallest items in a group of numerical data. See DISPERSION.

RECONCILE

To account for difference between separate sources of information for the same transaction. The tax auditor often will be confronted with differences between the taxpayer's records, tax work sheets, and returns filed.

RELIABILITY

1. (Auditing) The measure of confidence that may be placed in a set of records or reports. See REPLICATION.
2. (Statistics) Relative ability to repeat results in a given set of trials or experiments.

REPLICATION

The repetition of methods by which evidence is gathered. Thus, if under similar conditions of selection and verification, two independent examinations are made of a group of vouchers, each is a replication of the other, although the particular vouchers examined may not be the same.

The replication of audit methods may be regarded as a test of precision with which the procedures were carried out. See VALIDITY.

REPRESENTATIVE SAMPLE

Any random sample selected for observation, whether or not containing a determinable error. See PROBABILITY SAMPLE.

REVIEW

To examine critically any operation, procedure, condition, event, or series of transactions.

SAMPLE

A portion of a group of related transactions, financial statements, or other universe of data chosen to reflect or assist in determining the accuracy, propriety, or other characteristics of the whole. Sampling is an important element in the process of auditing. See TESTCHECK.

SAMPLING ERROR (Statistics)

Standard error of a sampling distribution.

SCAN

To look at the entries in an account, accounting record, or a group of accounts or records, for the purpose of testing general conformity to pattern, noting apparent irregularities, unusual items, or other circumstances appearing to require further study. The term indicates a general and rapid review as opposed to a detailed examination or substantiation of each item, and often a review requiring the skill of a practiced auditor and having as its purpose the discovery of the qualitative aspects of a procedure, classification, or account. See ANALYZE.

SCOPE

The character of an audit, primarily with reference to the procedures utilized in a particular audit, or the extent to which the transactions, records, or accounts examined serve as a basis of adequate testing and substantiation.

SHELF TEST

This is a general term for procedures used to determine the unit price of merchandise sold. In many instances, this is done by examining unit prices of merchandise on the shelves of the retailer. Unit sales prices also may be determined by examining catalogs, sales tickets, menus, contracts, etc.

SIGNIFICANT

1. Of sufficient magnitude, as measured by a departure from some norm or standard, to raise doubt that the deviation is the result of chance, random, or compensating factors; hence, indicating behavior calling for a better awareness or understanding of the cause, the removal of the cause, or a modification of the standard because of its inadequacy.
2. Of sufficient importance to warrant disclosure or the treatment accorded larger or more important items; likely to influence judgments or decisions; said of individual transactions, transaction groups, or other events or conditions peculiar to a given establishment.

SIGNIFICANT AMOUNT

A rounded-off number, as of dollars, conveying to the observer the same impression as would the fully expressed quantity.

SPECIAL AUDIT

An audit, having a special or general scope, for other than the regular periods or for other than customary purposes; a limited audit. See AUDIT.

STANDARD DEVIATION (Statistics)

A measure of dispersion: the square root of the average of the squares of the differences between a group of numbers and their arithmetic mean.

While other measures of dispersion, such as range and average deviation, are available, the preferred measure of dispersion in statistics is the standard deviation.

STATISTIC

Any value, such as an arithmetic mean, median, or standard deviation, calculated from a sample rather than a universe.

In accounting practice, "statistics" are sometimes distinguished from accounting data by the fact that the former may not tie in directly with the books of account and thus be subjected to the discipline of double-entry bookkeeping.

STRATIFIED SAMPLING (Statistics)

Drawing of random samples within strata of relatively homogeneous subgroups of the population. Generally, the strata are sampled independently so that sample results in one strata do not affect sampling procedures in other strata. The data may also be classified into strata on the basis of cost, ease, facility of handling materials, and other criteria, as well as statistical homogeneity.

SUBJECTIVE

Having a meaning or application reflecting the characteristics of the investigator, the peculiarities of his experience, or of the environment, and not substantiated by independent investigators: said of a fact, judgment, or inference.

SUBSTANTIATE

To insure the accuracy of, by weight of evidence; to verify.

SYSTEMATIC SAMPLING (Statistics)

A sample design or set of sampling procedures, frequently employed, wherein sampling units are selected at some fixed and designated interval, e.g., every fifth file card in a file system. A systematic sample qualifies as a random sample if the starting element is selected at random and every k th element (k, an integer) of the frame is selected thereafter.

TEST

1. A specified procedure or set of procedures, including rules or assembling evidence, interpretation, and significance for accepting or rejecting hypotheses.
2. As applied to the quality of a commodity or of a performance, a sample or sampling.

TESTCHECK

To verify selected items in an account or record for the purpose of arriving at an opinion of the correctness of the entire account or record; to sample. See SAMPLE; TEST.

TESTED

Records are examined to the extent deemed appropriate.

TESTING

The justification for testing rests largely upon the probability that irregularities are recurrent; that, once committed, they will be reported.

TRACE

To ascertain whether an item has been disposed of in accordance with source indications. The tracing of transactions is a necessary phase of the tax auditor's verification and is particularly important when establishing differences in test periods.

UNIVERSE

1. The whole of the subject matter of whatever is under consideration.
2. (Statistics) The entire matrix or group of data from which samples may be drawn; sometimes referred to as a population.

VALIDATE

1. To test for or to certify or attest to accuracy, precision, reliability, and relevance.
2. To do what is necessary to make effective or legal.

VALIDITY

As used in deductive logic; propriety established by a strong inference in which no inconsistency appears.

VERIFICATION

1. The procedure by which validity is ascertained.
2. The process of substantiation involved in providing by customary audit procedures that a statement, account, or item is accurate and properly stated, or to be within permissible or reasonable limits.

VERIFICATION OF POSTINGS

Verification of postings involves tracing original records to the books or original entry whose totals are then traced to postings in the general ledger.

VERIFY

To confirm the truth, accuracy, or probability of, by competent examination; to substantiate.

WEIGHTED AVERAGE

A simple average of items reduced to a common basis.

ACKNOWLEDGMENT

The principal source of the definitions included in this glossary appears below:

Eric L. Kohler, A DICTIONARY FOR ACCOUNTANTS,
3rd Ed., (C) 1963. Reprinted by permission of
Prentice–Hall, Inc., Englewood Cliffs, New Jersey.

Table of Exhibits

AUDIT PROCESS

EXHIBIT 1

1. Headquarters prepares a list of accounts eligible for audit.
2. District selects accounts from list and notifies headquarters of accounts selected
3. District prints copy of the transcript
4. Field Auditor Supervisor assigns audit to field auditor.
5. Auditor makes pre-audit review of district file and appropriate regulations.
6. Auditor makes telephone appointment, asks questions, and sends letter confirming start date.
7. Initial contact and examination of records is made.
8. Audit plan developed beased upon preliminary examination.
9. Audit data selected and examined.
10. Taxpayer reviews audit data and provides supporting documentation.
11. Auditor summarizes audit data - prepares appropriate memos.
12. Field auditor holds discussion with taxpayer field Audit Supervisory involved if necessary.
13. Auditor completes and submits audit report and disks to field Audit Supervisor.
14. Audit report sent to taxpayer — if T.P. disagrees, hearing process is initiated.
15. Audit transmitted to headquarters for billing.

FORM CDTFA–1164 — AUDIT MEMORANDUM OF POSSIBLE TAX LIABILITY

EXHIBIT 2

CDTFA-1164 REV. 17 (7-17)

AUDIT MEMORANDUM OF POSSIBLE TAX/FEE LIABILITY

STATE OF CALIFORNIA
CALIFORNIA DEPARTMENT OF TAX AND FEE ADMINISTRATION

TO — Auditing	FROM — Auditing
☐ **BUYER'S** — FILE	☐ **SELLER'S** — FILE
ACCOUNT NO.	ACCOUNT NO.
NAME	NAME
STREET	STREET
CITY / STATE/ZIP CODE	CITY / STATE/ZIP CODE
PHONE ( )	PHONE ( )
	WEB ADDRESS

NOTE: *Check one or more blocks as appropriate and choose applicable word(s) from drop-down fields.*

Records of the buyer show the following questioned transactions:

- ☐ Tax/Fee assessed in audit of buyer ____________ to ____________
- ☐ Seller has valid resale certificate from buyer on file *(attach copy of certificate to CDTFA-1164)*
- ☐ Buyer states that resale certificate was given
- ☐ Resale certificate was issued by the buyer for tools and supplies
- ☐ Sales tax was remitted to seller when paying the indicated ex-tax invoices
- ☐ Tax/Fee was not added on the invoice(s)
- ☐ Unregistered out-of-state retailer *(attach copy of invoice to CDTFA-1164)*
- ☐ Other *(describe)* ____________

ATTACH COPIES OF INVOICES **OR** SCHEDULE ITEMS BELOW

Date	Invoice No.	Purchase Order No.	Amount	Description of Merchandise	Shipped From

☐ See attached invoices and/or schedule.

Above listing covers ☐ Period to ☐ Sample Listing

COMMENTS AND RECOMMENDATIONS

AUDITOR	AUDITOR PHONE ( )	DATE

(References: Audit Manual sections 0401.20 and 0408.20)

SAMPLE MEMO, REPORT OF SUSPECTED MONEY LAUNDERING ACTIVITY — EXHIBIT 3

State of California — California Department of Tax and Fee Administration

M e m o r a n d u m

To **:** Deputy Director
Field Operations Department (MIC 47)

Date:

From **:** District Administrator

Subject : Report of Suspected Money Laundering Activity

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

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

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

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

POLICY AND PROCEDURE FOR SUBPOENA REQUESTS EXHIBIT 4

This exhibit has been removed because we were not able to conform them to the Web Content Accessibility Guidelines (WCAG 2.1) as required by Assembly Bill 434 (Stats. 2017, Ch. 780). Please email BTFD-BTCT-AM.RevisionSuggestions@cdtfa.ca.gov and provide a mailing address if you would like us to mail you a hardcopy.

EXAMPLE OF PRIOR AUDIT PERCENTAGE MEMO — EXHIBIT 5

State of California — California Department of Tax and Fee Administration

M e m o r a n d u m

Distributed Electronically

To **:** District Principal Auditor — **Date:** December 1, 20XX

From **:** Audit Supervisor

Subject : Request to Use a Prior Audit Percentage

ABC Company
SR KH 180-345678

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

(a) ABC Company
SR KH 180-345678

(b) The taxpayer is a manufacturer and distributor of consumer electronics.

(c) The audit period is 1/1/10 - 12/31/12

(d) The prior audit percentage would be used in the paid bills portion of the audit.

(e) For the prior audit period, 1/1/07 - 12/31/09, the percentage of error was 2.01 percent.

(f) For the prior audit period, 1/1/07 - 12/31/09, the population was $4,100,000.

(g) We propose the use of 2.01 percent in the current audit.

(h) The population to which this percentage of error will be applied is $5,600,000.

We have discussed this approach with the tax manager and she is agreeable to the use of the prior percentage of error. The tax manager was informed that this approach may only be extended to two subsequent audits. We both agree that given the relative consistency in the error rates, populations, accounting procedures, internal controls and personnel, the use of a prior percentage of error would save significant audit time while achieving substantially the same result as a new test.

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

cc: I. M. Auditor

* In the case of a second subsequent audit, the memo is sent to the District Principal Auditor and the Deputy Director, Field Operations Department for approval by both.

SAMPLE SALES TAX WORKING PAPER (WHOLE DOLLAR AUDITING) EXHIBIT 6

This exhibit has been removed because we were not able to conform them to the Web Content Accessibility Guidelines (WCAG 2.1) as required by Assembly Bill 434 (Stats. 2017, Ch. 780). Please email BTFD-BTCT-AM.RevisionSuggestions@cdtfa.ca.gov and provide a mailing address if you would like us to mail you a hardcopy.

STATE OF CALIFORNIA

CALIFORNIA DEPARTMENT OF TAX AND FEE ADMINISTRATION
450 N STREET, SACRAMENTO, CALIFORNIA 95814
PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-00XX
1-916-XXX-XXXX • FAX 1-916-XXX-XXXX
www.cdtfa.ca.gov

GAVIN NEWSOM
Governor

MARYBEL BATJER
Secretary, Government Operations Agency

NICOLAS MADUROS
Director

Tax Permittee

Use of "ABC" Letter Procedure to Verify Payment of Use Tax by Out-of-State Sellers

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

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

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

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

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

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

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

California Department of Tax and Fee Administration
Business Tax and Fee Division

CDTFA-503-A REV. 1 (1-18)

CDTFA-503-B REV. 2 (1-18) STATE OF CALIFORNIA

CALIFORNIA DEPARTMENT OF TAX AND FEE ADMINISTRATION

SAMPLE LETTER

Requesting Vendor's Statement

ABC Company

1234 5th Street

Any Town, CA 90000

Auditors of the California Department of Tax and Fee Administration (CDTFA) are currently examining our records in connection with the California Sales and Use Tax Law. They have questioned certain nontaxed sales made by you, as covered by the invoices listed on the attached sheet.

Since the CDTFA audits both the seller and the purchaser, it is very important that you respond to the enclosed document in order to assure that tax is assessed only once on each transaction.

Please review the enclosed document and complete the appropriate portions of it. As noted on the document, you may need to check more than one box for a transaction. The CDTFA will not accept the statement if it is not filled out completely and signed by an authorized representative.

Your prompt response is necessary for us to determine if tax has been paid on this/these transactions. Please return the enclosed document within 10 days using the enclosed envelope or fax to (_____) ______________.

CDTFA-503-C REV. 2 (1-18)

STATE OF CALIFORNIA

STATEMENT CONCERNING PROPERTY PURCHASED WITHOUT PAYMENT OF CALIFORNIA USE TAX

CALIFORNIA DEPARTMENT OF TAX AND FEE ADMINISTRATION

DMA ___________________

Auditor's Initials _____________

Please complete this inquiry statement regarding certain nontaxed sales you made to the customer listed below. Please fill out the form completely, check all the appropriate boxes, and sign as your company's authorized representative. The form should be returned within 10 days.

NAME OF CUSTOMER TO WHOM YOU SOLD ITEMS WITHOUT USE TAX

Invoice Date	Invoice Number	Amount	Description	Response List all boxes (a) through (g) that apply

Please mark all applicable boxes below and list in response area above.

☐ a. The tax was paid directly to the California Department of Tax and Fee Administration (CDTFA) as a result of an audit determination dated covering the period to . The CDTFA's audit specifically included the above transaction in the audit assessment.

☐ b. The tax was paid directly to the CDTFA as a result of an audit determination dated covering the period to . The CDTFA's audit examined our sales on a test basis with a percent of error computed and applied. The sales sampled in the audit were similar in nature to the above transaction. Accordingly, as a result of this audit we believe tax on the above transaction has been paid to the CDTFA.

☐ c. The CDTFA is in the process of auditing our company for the period to . The CDTFA is examining our sales to California customers. Accordingly, as a result of this audit we believe that tax on the above transaction(s) may be questioned by the CDTFA.

☐ d. I was engaged in business in the special tax district where the sold property was shipped or delivered and tax was or will be assessed as part of an audit by the CDTFA. This option should be used in conjunction with Item a, b, or c above.

☐ e. The property described on the above listed invoices was shipped from the city of in the State of .

☐ f. No sales or use tax was charged by our company on the above questioned document(s), however, the tax was reported and remitted by our company to the CDTFA on our tax return for the period .

☐ g. Our company has not paid the California sales or use tax to the CDTFA and we have not been audited for the same period for the transactions listed above.

COMMENTS

SELLER'S PERMIT NO.	SELLER'S NAME
SIGNATURE	TELEPHONE NO.
TITLE *(Owner, Partner, President, etc.)*	DATE

The information provided above is subject to verification by the California Department of Tax and Fee Administration.

FORM CDTFA-504-A/B/C - XYZ SAMPLE LETTER EXHIBIT 8

This exhibit has been removed because we were not able to conform them to the Web Content Accessibility Guidelines (WCAG 2.1) as required by Assembly Bill 434 (Stats. 2017, Ch. 780). Please email BTFD-BTCT-AM.RevisionSuggestions@cdtfa.ca.gov and provide a mailing address if you would like us to mail you a hardcopy.

FEDERAL ACQUISITION REGULATIONS (FAR'S) CLAUSE DEFINITIONS

EXHIBIT 9

This exhibit has been removed because we were not able to conform them to the Web Content Accessibility Guidelines (WCAG 2.1) as required by Assembly Bill 434 (Stats. 2017, Ch. 780). Please email BTFD-BTCT-AM.RevisionSuggestions@cdtfa.ca.gov and provide a mailing address if you would like us to mail you a hardcopy.

SAMPLE AUDIT PROGRAM EXHIBIT 10

This exhibit has been removed because we were not able to conform them to the Web Content Accessibility Guidelines (WCAG 2.1) as required by Assembly Bill 434 (Stats. 2017, Ch. 780). Please email BTFD-BTCT-AM.RevisionSuggestions@cdtfa.ca.gov and provide a mailing address if you would like us to mail you a hardcopy.

FORM CDTFA–837 — AFFIDAVIT FOR SECTION 6388 OR 6388.5 EXEMPTION EXHIBIT 11

CDTFA-837 Affidavit for Section 6388 or 6388.5 Exemption from the California Sales and Use Tax is available on CDTFA's public web site.

FORM CDTFA–52 — CERTIFICATE OF VERIFICATION OUT OF STATE DELIVERY EXHIBIT 12

This exhibit has been removed because we were not able to conform them to the Web Content Accessibility Guidelines (WCAG 2.1) as required by Assembly Bill 434 (Stats. 2017, Ch. 780). Please email BTFD-BTCT-AM.RevisionSuggestions@cdtfa.ca.gov and provide a mailing address if you would like us to mail you a hardcopy.

FORM CDTFA–52-L1 — SAMPLE LETTER SELLER RECEIPT OF GOODS IN INTERSTATE COMMERCE — EXHIBIT 12A

This exhibit has been removed because we were not able to conform them to the Web Content Accessibility Guidelines (WCAG 2.1) as required by Assembly Bill 434 (Stats. 2017, Ch. 780). Please email BTFD-BTCT-AM.RevisionSuggestions@cdtfa.ca.gov and provide a mailing address if you would like us to mail you a hardcopy.

FORM CDTFA–52–L1 — SAMPLE LETTER, AUDITOR EXHIBIT 12B

STATE OF CALIFORNIA

CALIFORNIA DEPARTMENT OF TAX AND FEE ADMINISTRATION
[ADDRESS 1]
[ADDRESS 2]
1-[XXX-XXX-XXXX] • FAX 1-[XXX-XXX-XXXX]
www.cdtfa.ca.gov

GAVIN NEWSOM
Governor

MARYBEL BATJER
Secretary, Government Operations Agency

NICOLAS MADUROS
Director

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

[Salutation]:

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

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

Sincerely,

[Name]
[Title]

Enclosure:
CDTFA-52, *Certificate of Verification, Out-of-State Delivery*

CDTFA-52-L1 REV. 2 (9-17)

FORM CDTFA–52–L2-B — SAMPLE LETTER FOR SELLER NOTICE OF PENDING REFUND OF EXCESS SALES TAX REIMBURSEMENT EXHIBIT 12C

CDTFA-52-L2B REV. 1 (9-17)

STATE OF CALIFORNIA
CALIFORNIA DEPARTMENT OF TAX AND FEE ADMINISTRATION

[Business Name]
[Name]
[Address]
[City, State, Zip Code]

Notice of Pending Refund of Excess Sales Tax Reimbursement – Credit/Check

[Customer Name]
[Address]
[City, State, Zip Code]

[Date]

Dear [Customer],

A review of our sales records indicates that your account is due a refund of tax reimbursement in the amount of [Amount] for the period [xx-xx-xx] to [yy-yy-yy]. You must sign and return this form by [xx-xx-xx] in order to process the refund. If you fail to respond by the requested date, it will be understood that you are not interested in a refund of the excess tax collected.

We have filed a claim for refund on your behalf with the California Department of Tax and Fee Administration (CDTFA) for the excess tax collected. Once in receipt of a refund from the CDTFA, money will be refunded to your account. The retailer is legally liable to repay the CDTFA any amounts of the tax that are not refunded to you. Please indicate if you would like the amount sent to you or credited to your account (if available with the retailer).

☐ Send the refund to me or ☐ Credit my account

Please acknowledge receipt of this notice by completing the information below and returning it to our office promptly. Keep a copy of this form for your files. In accordance with Sales and Use Tax Regulation 1700, the CDTFA will not issue a refund to the retailer until it receives this signed acknowledgment.

The validity of all refund claims are subject to review and approval by the CDTFA. Any issued refund checks not redeemed after 90 days of issuance will be voided and the amounts remitted back to the state.

CUSTOMER NAME	
BY *(print name)*	
SIGNATURE	TITLE
DATE	TELEPHONE ( )

Sincerely,

[Name]
[Title]

FORM CDTFA-698-A - INFORMATION DOCUMENT REQUEST -- INITIAL IDR EXHIBIT 13

This exhibit has been removed because we were not able to conform them to the Web Content Accessibility Guidelines (WCAG 2.1) as required by Assembly Bill 434 (Stats. 2017, Ch. 780). Please email BTFD-BTCT-AM.RevisionSuggestions@cdtfa.ca.gov and provide a mailing address if you would like us to mail you a hardcopy.

FORM CDTFA-698-A - INFORMATION DOCUMENT REQUEST -- SECOND IDR EXHIBIT 14

This exhibit has been removed because we were not able to conform them to the Web Content Accessibility Guidelines (WCAG 2.1) as required by Assembly Bill 434 (Stats. 2017, Ch. 780). Please email BTFD-BTCT-AM.RevisionSuggestions@cdtfa.ca.gov and provide a mailing address if you would like us to mail you a hardcopy.

FORM CDTFA-698-C, INFORMATION DOCUMENT REQUEST MASTER LOG

EXHIBIT 15

This exhibit has been removed because we were not able to conform them to the Web Content Accessibility Guidelines (WCAG 2.1) as required by Assembly Bill 434 (Stats. 2017, Ch. 780). Please email BTFD-BTCT-AM.RevisionSuggestions@cdtfa.ca.gov and provide a mailing address if you would like us to mail you a hardcopy.

FORM CDTFA-699-B, FORMAL NOTICE AND DEMAND COMPLETED EXAMPLE

EXHIBIT 16

This exhibit has been removed because we were not able to conform them to the Web Content Accessibility Guidelines (WCAG 2.1) as required by Assembly Bill 434 (Stats. 2017, Ch. 780). Please email BTFD-BTCT-AM.RevisionSuggestions@cdtfa.ca.gov and provide a mailing address if you would like us to mail you a hardcopy.

FORM CDTFA-699 - AUDIT FINDINGS PRESENTATION SHEET EXHIBIT 17

This exhibit has been removed because we were not able to conform them to the Web Content Accessibility Guidelines (WCAG 2.1) as required by Assembly Bill 434 (Stats. 2017, Ch. 780). Please email BTFD-BTCT-AM.RevisionSuggestions@cdtfa.ca.gov and provide a mailing address if you would like us to mail you a hardcopy.

FORM CDTFA-699-A, AUDIT FINDINGS PRESENTATION SHEET MASTER LOG

EXHIBIT 18

This exhibit has been removed because we were not able to conform them to the Web Content Accessibility Guidelines (WCAG 2.1) as required by Assembly Bill 434 (Stats. 2017, Ch. 780). Please email BTFD-BTCT-AM.RevisionSuggestions@cdtfa.ca.gov and provide a mailing address if you would like us to mail you a hardcopy.

EXAMPLES OF TAX EXEMPTION CARDS EXHIBIT 19

This exhibit has been removed because we were not able to conform them to the Web Content Accessibility Guidelines (WCAG 2.1) as required by Assembly Bill 434 (Stats. 2017, Ch. 780). Please email BTFD-BTCT-AM.RevisionSuggestions@cdtfa.ca.gov and provide a mailing address if you would like us to mail you a hardcopy.

SAMPLE JURIS GRID - PARTIAL EXEMPTION FOR MANUFACTURING AND RESEARCH & DEVELOPMENT EQUIPMENT EXHIBIT 20

This exhibit has been removed because we were not able to conform them to the Web Content Accessibility Guidelines (WCAG 2.1) as required by Assembly Bill 434 (Stats. 2017, Ch. 780). Please email BTFD-BTCT-AM.RevisionSuggestions@cdtfa.ca.gov and provide a mailing address if you would like us to mail you a hardcopy.

TAXABLE SALES PERCENTAGE METHOD — EXHIBIT 21

Taxable Sales Percentage Application					
A	B	C	D	E	F
Taxpayer Records	Taxpayer Records	(A + B)	(C * 75%)	(D – D/ (1 + 8.25%))	(D – E)
Gross Retailer(s) write off for period Tax Included (Per lender's books and records)	Less amounts not subject to refund (finance costs, i.e., late fees, interest, penalties, etc.)	Net principal write off Tax Included	Retailer taxable percentage Tax included (i.e. 75%)	Less tax included in principal (i.e. 8.25%)	Net principal measure subject to refund Ex-tax
1,000,000.00	(100,000.00)	900,000.00	675,000.00	(51,443.42)	623,556.56

<u>**Note 1:**</u> Additional adjustment (reduction) may need to be made to the principal for amounts included in the principal that were added by the lender during the financing process (i.e. late fees, penalties, etc.). See column B.

<u>**Note 2**</u>: Retailer's Taxable Percentage is subject to CDTFA's review of retailer's records.

<u>**Note 3:**</u> Lenders are required to obtain and retain a yearly statement showing the retailers California taxable sales percentage for the calendar year at issue.

<u>**Note 4:**</u> In most cases, Column C, which is the net principal write off amount, will include sales tax. Thus, Column D, the retailer's taxable percentage, must also be tax included. The sales tax is then removed as shown in Column E to arrive at the net allowable refund measure, ex tax.