

Audit Manual

Chapter 5

Penalties

Business Tax and Fee Division
*California Department of
Tax and Fee Administration*

This is an advisory publication providing direction to staff administering the Sales and Use Tax Law and Regulations. Although this material is revised periodically, the most current material may be contained in other resources including Operations Memoranda and Policy Memoranda. Please contact any California Department of Tax and Fee Administration office if there are concerns regarding any section of this publication.

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PENALTIES**0500.00****INTRODUCTION****0501.00****CALIFORNIA DEPARTMENT OF TAX AND FEE****ADMINISTRATION (CDTFA) POLICY ON PENALTIES****0501.05**

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

**RESPONSIBILITY OF FIELD AUDITORS
FOR PENALTY RECOMMENDATIONS****0501.15**

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

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

**TYPES OF PENALTIES — SALES AND USE TAX ACCOUNTS
MANDATORY VS DISCRETIONARY PENALTIES****0501.22**

Numerous sections of the Revenue and Taxation Code (RTC) impose penalties. Some penalties are mandatory and are imposed automatically. Other penalties are discretionary and may be assessed by auditors in the conduct of their audits. (See AM 0203.21 for typical explanations of penalty recommendations in sales and use tax audits.) Whenever circumstances warrant the imposition of either a mandatory or a discretionary penalty, but not both, *the mandatory penalty will apply*. For example, the penalty for failure to file a return (mandatory penalty) rather than the negligence penalty (discretionary penalty) will be applied in those cases where either penalty is applicable.

PENALTIES

TYPES OF PENALTIES - OVERVIEW MANDATORY VS DISCRETIONARY PENALTIES

(CONT.) 0501.22

Mandatory Penalties

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

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

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

^c The rate of penalty is increased to 25 percent if the supplier or wholesaler knowingly or intentionally fails to make a timely remittance of the prepayment amounts.

Discretionary Penalties

Negligence or intentional disregard of the law or authorized rules and regulations	10%	6478; 6484
Fraud or intent to evade the law or authorized rules and regulations	25%	6485; 6514
Improper use of a resale certificate for personal gain to evade the tax	^d	6072; 6094.5
Failure to remit sales tax reimbursement or use tax collected	40% ^e	6597
Knowingly fails to obtain a valid permit for the purpose of evading the payment of tax	50%	7155
Registration of a vehicle, vessel, or aircraft outside the State of California for the purpose of evading the payment of tax	50%	6485.1; 6514.1
Failure to obtain evidence that the operator of catering truck holds a valid seller's permit	\$500	6074
Failure of a retail florist to obtain a permit before engaging in or conducting business as a seller	\$500 ^f	6077

^d 10% of the tax due or \$500 whichever is greater.

^e RTC section 6597 operative January 1, 2007.

^f Plus any other applicable penalties.

**TYPES OF PENALTIES - SPECIAL TAX AND FEE ACCOUNTS
MANDATORY VS DISCRETIONARY PENALTIES**

0501.23

The mandatory and discretionary penalties applicable to special tax and fee accounts are presented in the following tables. After the tables, several specific circumstances are provided where multiple penalties may or may not be assessed in special tax and fee cases. Whenever circumstances warrant the imposition of both a mandatory and a discretionary penalty, but the law precludes imposing both penalties, *the mandatory penalty will apply.*

Mandatory Penalties

Nature of Penalty	Rate	RTC Sections
Unlicensed person (Diesel Fuel and Cigarettes and Tobacco Products)	25% or \$500, whichever is greater	30211, 60361 ¹
Unlicensed person (Motor Vehicle Fuel)	25%	7726(b)
Unlicensed person (Use Fuel Tax)	\$100 times the total number of penalties imposed up to \$1,000	9351
Failure to pay timely	10%	7655(a), 8876(a), 30281(a), 40101(a), 41095(a), 43155(a), 45153(a), 46154(a), 50112(a), 55042(a), 60207(a), 12631, 32252(a) ²
Failure to pay (Cannabis Tax)	50%	34013(e)
Failure to file timely	10%	7655(b), 8876(b), 32252(b) ³ , 30281(b), 40101(b), 41095(b), 43155(b), 45153(b), 46154(b), 50112(b), 55042(b), 60207(b)
Failure to file a return	10%	7660, 8801, 12633, 30221, 32291 ⁴ , 40081, 41080 ⁵ , 46251, 60301

¹ Per 60361(b) if it is determined no tax is due, there is a penalty of \$100 for the first violation and increasing by \$100 for subsequent violation, up to a maximum penalty of \$500.

² Per 32252(c) the penalties imposed by this section shall be limited to either the \$50 provided in subdivision (b), or 10% of the tax provided in subdivision (a), whichever is greater.

³ Per 32252(c) the penalties imposed by this section shall be limited to either the \$50 provided in subdivision (b), or 10% of the tax provided in subdivision (a), whichever is greater.

⁴ If due to negligence, there shall be added to the tax a penalty equal to 10% thereof in addition to the 10% penalty. If due to fraud or intent to evade the tax, there shall be added to the tax a penalty equal to 25% thereof in addition to the 10% penalty.

⁵ Per 41080, a penalty equal to 10% or \$10, whichever is greater.

PENALTIES

**TYPES OF PENALTIES - SPECIAL TAX AND FEE ACCOUNTS
MANDATORY VS DISCRETIONARY PENALTIES**

(CONT. 1) 0501.23

Nature of Penalty	Rate	RTC Sections
Backup tax	25% or \$500, whichever is greater	7727(b), 60361.5
Failure to pay prepayment timely	10%	12258, 43155(a)
Failure to pay prepayment timely	6%	7659.5
Failure to make prepayment, but files timely return and payment	6%	7659.6
Failure to file prepayment timely	10%	43155(b)
Failure of Electronic Fund Transfer (EFT) filer to file return timely	10%	7659.9(d), 8760(d), 30190(d), 32260(d), 40067(d), 41060(d), 43170(d), 45160(d), 46160(d), 50112.7(d), 55050(d), 60250(d)
Failure of EFT filer to remit payments (exclusive of prepayments) by EFT	10%	7659.9(e), 8760(e), 12601(c)(1), 30190(e), 32260(e), 40067(e), 41060(e), 43170(e), 45160(e), 46160(e), 50112.7(e), 55050(e), 60250(e)
Failure of EFT filer to make timely payment	10%	7659.9(f), 8760(f), 30190(f), 32660(f), 40067(f), 41060(f), 43170(f), 45160(f), 46160(f), 50112.7(f), 55050(f), 60250(f)
Failure to pay prepayments by EFT (Motor Vehicle Fuel)	6%	7659.9(e)(2)
Failure to pay cigarette stamps and meter register settings	6%	30171

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TYPES OF PENALTIES - SPECIAL TAX AND FEE ACCOUNTS

MANDATORY VS DISCRETIONARY PENALTIES

(CONT. 2) 0501.23

Nature of Penalty	Rate	RTC Sections
Fraud or intent to evade	25%	7662, 7673, 8780, 8804, 12635, 30205, 30224, 32271, 32291, 40075, 40084, 41074 ⁶ , 41083 ⁷ , 43201(c), 45201(c), 46201(d), 46254, 50113(c), 55061(c), 60303, 60313
Negligence	10%	7672, 8779, 12634, 30204, 32271, 40074, 41073, 43201(b), 45201(b), 46201(c), 50113(b), 55061(b), 60312
Misuse of exemption certificate	25% or \$1,000, whichever is greater	7405(b), 60106.3(b), 60503.2(b)
Dyed diesel fuel	The greater of \$10 per gallon or \$1,000 times the total number of penalties imposed	60105(b)

Unlicensed Supplier/Distributor

The mandatory penalty for operating as an unlicensed supplier/distributor under the Diesel Fuel Tax Law and Cigarette and Tobacco Products Tax Law is 25 percent or \$500, whichever is greater. The mandatory penalty for operating as an unlicensed supplier/distributor under the Motor Vehicle Fuel Tax Law is 25 percent. The penalty for operating as an unlicensed supplier is immediately due and payable. When applying this penalty, neither the 10 percent failure to pay timely penalty nor the 10 percent failure to file timely penalty should be applied. The penalty for operating as an unlicensed supplier/distributor must be applied first. However, where the Business Tax and Fee Division (BTFD) determines that the failure to secure a license was due to reasonable cause, and the penalty is waived, the applicable 10 percent penalty (failure to pay timely or failure to file timely) should be applied.

Cannabis Tax

The mandatory failure to pay penalty under the Cannabis Tax Law is 50 percent. This penalty is applied in addition to the 10 percent failure to pay timely penalty or the 10 percent failure to file penalty.

⁶Per 41074, a penalty equal to twenty-five percent (25%) or twenty five dollars (\$25), whichever is greater.

⁷Per 41083, a penalty equal to twenty-five percent (25%) or twenty five dollars (\$25), whichever is greater. This shall be in addition to the penalties applied under 41080.

PENALTIES

TYPES OF PENALTIES - SPECIAL TAX AND FEE ACCOUNTS MANDATORY VS DISCRETIONARY PENALTIES

(CONT. 3) 0501.23

Backup Tax

The mandatory backup tax penalty under the Diesel Fuel Tax Law and Motor Vehicle Fuel Tax Law is 25 percent or \$500 and is immediately due and payable. When applying this penalty, neither the 10 percent failure to pay timely penalty nor the 10 percent failure to file penalty should be applied. The backup tax penalty must be applied first. However, where the CDTFA determines that the delivery into the fuel tank of a highway vehicle, or sale and delivery into the fuel tank of a highway vehicle of untaxed fuel was due to reasonable cause and circumstances beyond the person's control, and the penalty is waived, the applicable 10 percent penalty should be applied.

Fraud

The 25 percent fraud penalty and the 10 percent failure to file or failure to pay penalties may be imposed on the same liability when appropriate. There is no relief provision for the fraud penalty.

Negligence

A negligence penalty and a fraud penalty are not applied concurrently. The two penalties are mutually exclusive. The same is true of the negligence penalty and the penalty for failure to file a return. The penalty for failure to file a return (mandatory penalty) rather than the negligence penalty (discretionary penalty) will be applied in those cases where either penalty is applicable.

REVIEW AND APPROVAL OF RELIEF REQUESTS**0501.25****RELIEF REQUESTS IN GENERAL**

The CDTFA may grant relief from penalties, interest, and/or collection cost recovery fees or grant extensions for filing returns or making payments. The CDTFA is empowered to relieve taxpayers of mandatory penalties when it determines that the failure to pay taxes or file a return timely was due to a reasonable cause and circumstances beyond the person's control. Such failure must have occurred notwithstanding the exercise of ordinary care and the absence of willful neglect. Taxpayers wishing to request relief from the payment of penalties should do so after receipt of a determination.

Requests for relief are generally submitted online at the CDTFA website. Staff should encourage taxpayers without Internet access to visit a field office or another location with secure Internet access to complete the request. However, if these options are not possible, staff may print and mail the following forms:

- CDTFA-735, *Request for Relief from Penalty, Collection Cost Recovery Fee, and/or Interest*
- CDTFA-135-A, *Declaration of Timely Mailing*
- CDTFA-468, *Request for Extension of Time to File a Tax Return*

In cases where a paper request is received in a field office, staff should forward the document to the appropriate headquarters section, unit, or branch. For sales and use tax or lumber fee, requests relating to self-assessed liabilities are processed by the Return Analysis Unit (RAU), and requests relating to CDTFA-assessed liabilities are generally processed by the Petitions Section. For Special Taxes and Fees accounts, requests relating to self-assessed liabilities are processed by the Program and Compliance Bureau, and requests relating to CDTFA-assessed liabilities are generally processed by the Appeals and Data Analysis Branch. The requests are entered in the system by headquarters staff.

Field office staff has a responsibility to make appropriate recommendations to headquarters sections or units processing requests; for example, if they have knowledge that a request is not well-founded. For more information about the processing of penalty relief requests, see the Compliance Policy and Procedures Manual (CPPM) sections 535.010 through 535.017

PENALTIES

PROCEDURES FOR RELIEF OF PENALTY RECONSIDERATION

0501.27

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

A. Penalties of \$50,000 or Less

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

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

B. Penalties in excess of \$50,000

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

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

PENALTIES FOR NEGLIGENCE AND FRAUD

0501.30

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

When a "fraud" or "intent to evade" penalty has been imposed (i.e., billed on a Notice of Determination), any relief of such penalty shall be made only by the Deputy Director, Business Tax and Fee Division (BTFD).

LOCAL AND TRANSACTIONS TAXES

0501.35

The penalty provisions of this chapter also apply to Uniform Local Sales and Use Taxes and Transactions (Sales) and Use Taxes. The penalties for negligence and evasion normally will apply to state, local, and transactions taxes. However, a recommendation for penalty may be applied to only one or two of the three taxes, as appropriate.

SALES TAX RETURNS**0502.00****REPORTING BASIS****0502.10**

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

DUE DATES OF RETURNS**0502.15**

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

Quarterly Basis

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

Irregular Quarterly Basis

For sales tax accounts that are on a 13-month year accounting cycle and are reporting quarterly over a period of 13 months, returns are due on or before the last day of the month following the close of the authorized reporting period.

Monthly Basis

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

Yearly Basis

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

When changing an account from a yearly or fiscal year basis to another basis, and the effective date is other than the beginning of the yearly reporting period, the district will furnish the taxpayer with a return to report the expired portion of the year to and including the last day of the quarter which precedes the effective date of the new basis. The tax return for the expired portion of the year is due on or before the last day of the month following the effective date of the new basis.

SALES TAX LIABILITY OF PURCHASERS**0502.20**

A purchaser, as provided in RTC section 6421, who becomes liable for payment of sales tax as if the purchaser was a retailer making a retail sale has an obligation to file returns and is subject to the failure to file penalty provisions of RTC section 6511 if a return is not timely filed.

CLOSEOUTS**0502.30**

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

PENALTIES

EFFECT OF LEGAL HOLIDAYS AND WEEKENDS ON DUE DATES 0502.35

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

New Year's Day	January 1
Martin Luther King, Jr. Day	3rd Monday in January
President's Day	3rd Monday in February
Cesar Chavez Day	March 31
Memorial Day	Last Monday in May
Independence Day	July 4
Labor Day	1st Monday in September
Veterans Day	November 11
Thanksgiving Day	4th Thursday in November
Day after Thanksgiving	Friday after Thanksgiving
Christmas	December 25

If a listed legal holiday falls on a Sunday, the holiday is observed on the following Monday. If Veterans Day falls on a Saturday, the preceding Friday is observed as a legal holiday.

STATUTORY DATE FALLING ON SATURDAY, SUNDAY OR HOLIDAY 0502.36

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

1. Waiving the statute of limitations (RTC section 6488)
2. Filing a petition for redetermination (RTC sections 6538 & 6561)
3. Filing a claim for refund (RTC section 6902)
4. Filing a suit for refund (RTC sections 6933 & 6934)
5. Issuing a determination (RTC section 6487)

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

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

EXTENSIONS FOR FILING RETURNS**0502.40**

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

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

Requests for an extension of time should be submitted on the CDTFA website. See AM 0501.25 for more information about how a taxpayer should submit a request. Some requests may be granted automatically if they meet certain criteria.

When an extension is granted for a specific period, a late penalty will not apply if the tax is paid on or before the last day of the period for which the extension was granted. However, when an extension is granted, interest from the date on which tax would have been due must be paid. In cases in which an extension of time has been granted for making a prepayment, interest applies to the unpaid amount of the required prepayment.

PENALTIES

FAILURE TO FILE A RETURN

0503.00

WHEN PENALTY APPLIES

0503.05

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

Under RTC section 6487, the determination for failure to file a return must be mailed within eight years after the last day of the calendar month following the quarterly period for which the amount is proposed to be determined. For eligible amnesty reporting periods, the determination may be issued within ten years from the due date of the tax (RTC section 7073(d)).

WHAT CONSTITUTES FILING A RETURN OR REPORT

0503.15

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

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

When the taxpayer has shown due diligence in making every effort to submit what the taxpayer feels is a return, the correspondence submitted should be accepted as a return. Even if the correspondence has no gross sales or deductions and shows only the net tax figure, it may be accepted as a return if the information listed in a, b, and c above is provided. If a taxpayer's check indicates the reporting period and the measure of the tax being paid, it may be processed as a return. As a general rule, if tax due can be calculated from the information provided, the correspondence should be processed as a return. It is important to always consider the taxpayer's intent.

FORM CDTFA-401-E, NOT A RETURN FOR ALL PURPOSES

0503.20

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

CLOSEOUTS WITH SECURITIES**0503.30**

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

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

Penalty for failure to file will apply if a taxpayer submits a late return even when security is available. Penalty for failure to file will also apply even when security is available to clear delinquent reporting periods. A note is added on the billing to inform the taxpayer of the type of penalty being applied.

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

- a. When a return was filed and an audit is in process —
Form CDTFA-414-A, *Report of Field Audit*, may include a penalty for negligence.
- b. When no return was filed and an audit is in process —
Form CDTFA-414-A will include the penalty for failure to file for the amount of the taxes, exclusive of prepayments, with respect to the period for which a return was required.

A notation on Form CDTFA-414-A under “Special Instructions” should be made when a security is available. See AM section 0204.12.

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

ERRONEOUS REFUNDS OF SECURITY DEPOSITS**0503.35**

If a security deposit available on the closeout date is erroneously refunded instead of being applied to a liability, no penalty or interest will be assessed where these charges would have accrued solely because of the erroneous refund. Interest will start to accrue if such liability is unpaid 30 days after the mailing of a notice of determination for repayment of the erroneous refund. In cases where there was no liability at the time the refund was made and a liability later developed, applicable penalty and interest will be added.

NO RETURNS FILED FOR PERIOD PRECEDING CLOSING PERIOD 0503.40

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

PENALTIES

TAXPAYERS ON A MONTHLY BASIS

0503.45

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

AVAILABILITY OF SECURITY BETWEEN BUSINESS TAXES

0503.50

All or the remainder of the security of a taxpayer's account may be transferred to another account of the same taxpayer. Information relative to the transfer is contained in the CPPM Chapter 4, *Security*.

MORE THAN ONE LOCATION

0503.55

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

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

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

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

FAILURE TO PAY**0504.00****WHEN PENALTY ATTACHES****0504.05**

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

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

PETITIONS FOR REDETERMINATION**0504.10**

RTC section 6565 imposes a 10 percent penalty for failure to pay the amount of any determination made by the CDTFA which is not paid on or before the date the determination becomes final (30 days after service¹ of notice of determination), unless a petition for redetermination is filed on or before that date. The rules for determining when a petition was filed are the same as those for determining when a payment was made.

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

PAYMENTS OR PETITIONS MAILED BUT NOT RECEIVED**0504.15**

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

JEOPARDY DETERMINATIONS**0504.20**

Jeopardy determinations become final within 10 days after service of notice unless a petition for redetermination is filed within such period and security is deposited within such period in such amount as the CDTFA may deem necessary. The CDTFA will not recognize a petition in connection with a jeopardy determination unless such security is deposited with the CDTFA in one or more of the following forms:

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

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

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

PENALTIES

PREPAYMENTS

0504.25

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

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

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

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

ELECTRONIC FUND TRANSFER RELATED PENALTIES

0504.30

The penalties imposed in RTC sections 6479.3 and 6591 apply to taxpayers who are required to pay taxes by means of Electronic Fund Transfer (EFT) and fail to do so. The penalties imposed under RTC sections 6479.3 and 6591 are limited to a maximum of 10 percent of the amount of taxes, exclusive of prepayments, for the reporting period. Failure to pay prepayments by electronic funds transfer is subject to a penalty of 6 percent of the prepayment amount incorrectly remitted (RTC section 6479.3 (e)(2)).

AMNESTY PENALTIES**0505.00**

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

50 PERCENT INTEREST PENALTY**0505.05****A. Application**

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

Qualified for amnesty but did not participate.

Participated in amnesty but underreported their tax liabilities.

Applied for amnesty but who did not enter into an Installment Payment Agreement (IPA) or pay their tax liability by May 31, 2005.

The penalty does not apply to:

Tax liabilities for eligible tax reporting periods that were included in an IPA in place on January 31, 2005.

Tax liabilities included in an amnesty IPA, even if the taxpayer subsequently defaults on its agreement.

Tax liabilities for reporting periods not eligible for amnesty, for example, reporting periods for which a criminal court proceeding had been initiated against the taxpayer prior to amnesty.

Eligible tax reporting periods where the tax portion of the liability was paid in full on or prior to March 31, 2005 (non-participant) or May 31, 2005 (participant).

B. Computation

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

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

DOUBLE PENALTIES**0505.10**

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

NEGLIGENCE PENALTIES — GENERAL 0506.00**LEGAL BASIS 0506.05**

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

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

DEFINITION 0506.10

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

NEGLIGENCE VS. INTENTIONAL DISREGARD 0506.15

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

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

ACTS OF AN AGENT, EMPLOYEE OR PARTNER 0506.20

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

CONDITIONS UNDER WHICH PENALTY APPLIES 0506.25

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

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

PENALTIES APPLICABLE TO ONLY PART OF AUDIT PERIOD**0506.30**

Situations may be encountered where the condition warranting the imposition of a negligence penalty is not present during the entire period under audit and where the imposition of the penalty to the entire amount of the tax liability would be inequitable. For example, a complete change of management occurred and conditions under one management were entirely different from those under the other. In this type of situation the auditor will prepare two sets of Form CDTFA-414-A or Form CDTFA-414-B, one includes the 10 percent penalty, and the other without the penalty. Audit Determination and Refund Section will issue the Notice of Determination accordingly. The audit report with the penalty must include a full statement of the facts involved.

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

**PENALTY COMMENTS ON AUDIT REPORTS
OR FIELD BILLING ORDERS****0506.35**

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

The factors which constitute negligence in keeping records (AM section 0507.00), negligence in preparing returns (AM section 0508.00), and evasion penalties (AM section 0509.00), must be carefully considered before determining whether a negligence or evasion penalty should be imposed. If a negligence penalty is being recommended, the auditor must provide in clear and concise terms the rationale for imposing a penalty. An explanation of the evidence and facts upon which the auditor relies to support the recommendation for imposition of a penalty must be given. The explanation must enable supervisors, reviewers, the taxpayer and/or taxpayer's representative to determine whether the recommendation is consistent with the facts established by the audit. The comments must be factual, not merely the auditor's opinion, and must not be stated in a manner derogatory to the taxpayer or the taxpayer's employees. All penalty comments must be sufficiently clear to provide information that may be useful in subsequent audits of the taxpayer.

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

If an evasion (fraud) penalty is being recommended, the comment on the audit report must include "Penalty pursuant to RTC section 6485 is recommended". In addition, a memorandum is required from the Administrator to the Chief, Headquarters Operations Bureau (see AM section 0509.75 for contents of this memorandum).

PENALTIES

PENALTY COMMENTS ON AUDIT REPORTS OR FIELD BILLING ORDERS

(CONT.) 0506.35

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

- Audit tax deficiency over \$25,000 — Reviewed and approved by the auditor's supervisor.
- Audit tax deficiency over \$50,000 — Reviewed and approved by the Office Making Audit (OMA) Principal Auditor subsequent to the review and approval by the auditor's supervisor.

Supervisors and Principal Auditors will be deemed to have reviewed and approved penalty comments when they indicate their approval of the audit as a whole on the digital audit email approval chain (See AM section 0213.06).

NEGLIGENCE PENALTIES IN A TAXPAYER'S FIRST AUDIT

0506.40

Field auditors are frequently faced with the decision of whether to recommend a penalty on the first audit of a taxpayer. This decision must be based on an objective evaluation of the audit findings and the taxpayer's background and experience. Generally, a penalty should not be recommended. However, there are circumstances where a penalty would be appropriate. (See Regulation 1703(c)(3)(A).) If a negligence penalty is recommended on the first audit, the comment "Taxpayer's first audit" should be made in conjunction with a detailed explanation for the penalty recommendation. Criteria that should be considered, among others, are the taxpayer's prior business experience, the nature and state of the records provided, and whether the taxpayer used an outside accountant or bookkeeper to compile and maintain the records, and/or to prepare the sales and use tax returns.

Circumstances in which a negligence penalty may be appropriate in a first-time audit include, but are not limited to, the following:

- The business is controlled by a person or persons that control (or controlled) a substantially similar business that was previously subject to audit. In that earlier audit, staff documented audit issues which resulted in the understatement of taxable sales. These same issues are present in the current audit and resulted in a substantial understatement of taxable sales. (For purposes of this and the following circumstances, "controlled" or "control" means any person having control or supervision of, or who is charged with the responsibility for, the filing of returns or the payment of tax or who has a duty to act for the entity in complying with any provision of the Sales and Use Tax Law.); or
- The business received written advice from the CDTFA regarding a record keeping or reporting issue. In the current audit that advice was clearly disregarded, leading to a substantial understatement of taxable sales. (For purposes of this and the following circumstance, "written advice" does not include publications provided to a taxpayer upon registration for a seller's permit or certificate of registration – use tax.); or
- The business is controlled by a person or persons that control (or controlled) a similar business which received written advice from the CDTFA regarding a record keeping or reporting issue. In the current audit that advice was clearly disregarded, leading to a substantial understatement of taxable sales; or

- The owner of the business has a history of opening and closing businesses. The owner opens a business, runs it for a year or two, closes it, and then opens a similar business. The owner subsequently closes the new business before any audit is performed, and then opens another, similar business, with the pattern continuing over many years. No audit was ever performed on any of the prior businesses, in part because the businesses closed before an audit would normally have been performed. The current audit reveals substantial underreporting which appears to be intentional, but the evidence is not sufficient to meet the clear and convincing evidence standard required to impose a fraud penalty; or
- The business has no records of any kind or extremely poor records, which resulted in substantial underreporting. The evidence indicates that it is more likely than not that the lack of records is intentional and is intended to conceal the underreporting; however, the evidence is not sufficient to meet the clear and convincing evidence standard required to impose a fraud penalty; or
- The business is controlled by a CPA or former CPA who has prior experience advising businesses of the same type on compliance with the Sales and Use Tax Laws. The audit results in a substantial liability despite the controlling person's extensive experience advising clients of the same type of business on record keeping and in preparing sales and use tax returns.

The following examples illustrate when a negligence penalty may apply in a taxpayer's first audit.

Example 1

Shep Bartlett owned and operated a restaurant serving breakfast, lunch and dinner as well as beer and wine. During an audit of the restaurant, Mr. Bartlett provided CDTFA staff with monthly sales summaries but had not maintained any source documentation like purchase invoices, sales receipts or cash register z-tapes. CDTFA staff found that taxable sales were understated. In the audit work papers, it was documented that Mr. Bartlett had been advised that he was required to maintain source documents and provide them upon audit. Subsequently, Mr. Bartlett formed a corporation, Bartlett, Inc., with himself as the president and sole shareholder. Bartlett, Inc. opened another restaurant which was managed by Mr. Bartlett. During the first audit of Bartlett Inc., CDTFA staff found that it did not maintain any source documentation such as purchase invoices, sales receipts or cash register z-tapes, and, upon examination, calculated a substantial understatement of taxable sales. Because the same audit issue was documented in the earlier audit of Mr. Bartlett's other restaurant and documentation showed that CDTFA staff had advised Mr. Bartlett regarding proper record keeping, and because Mr. Bartlett managed the operation of both restaurants, CDTFA staff recommended that a 10 percent negligence penalty be added to the audit determination.

Example 2

Tony Leo owned and operated a retail store selling antiques to customers both within and outside of California. Mr. Leo wrote to the CDTFA requesting advice regarding what documentation was necessary to support sales in interstate commerce. CDTFA staff provided him a written response stating that sales where the property was delivered to the customer in California were subject to sales tax while sales where documentation showed that the property was to be shipped and was shipped to a location outside California by common carrier were not subject to tax. During the first audit of the antique store, CDTFA staff discovered that Mr. Leo was claiming as exempt sales in interstate commerce sales where the property was delivered to the customer in California. Because Mr. Leo had previously received written advice on this issue and was reporting sales contrary to the specific written advice, CDTFA staff recommended that a 10 percent negligence penalty be added to the audit determination.

Note: The recommendation to impose a 10 percent negligence penalty would also apply in the first audit of a business which is controlled by a person or persons that control (or controlled) a similar business which received written advice from the CDTFA regarding a record keeping or reporting.

Example 3

Ace's Automobiles is a seller of used vehicles. It was opened and originally operated under a seller's permit taken out by Charlotte Dealer. After two years, the business was closed and Ms. Dealer opened King's Automobiles, also selling used vehicles. Ms. Dealer closed King's Automobiles after two years and opened Jack's Automobiles, again selling used vehicles. Ms. Dealer managed all three businesses. Based on an audit lead, staff commenced an audit of Jack's Automobiles after it had been in business only two years. This was the first audit of any of Ms. Dealer's businesses. Audit staff found that many of the Reports of Sale were missing and the records they did obtain appeared to have been prepared just for the audit and indicated unrealistically low selling prices based on the make and model of vehicles sold. As a result, staff estimated that taxable sales were substantially understated. Although this was Ms. Dealer's first audit, because Ms. Dealer had been operating used vehicle lots for many years and her past business practices indicated a conscious effort to avoid being audited, staff recommended that a 10 percent negligence penalty be added to the audit determination.

Example 4

Kurt Vaughn owned and operated a company in the business of selling musical instruments. Mr. Vaughn did not report any taxable sales, claiming that all property was shipped out of state via common carrier pursuant to the sales contracts. During the first audit of the business, Mr. Vaughn provided annual sales summaries but did not maintain purchase invoices, sales contracts or receipts, shipping invoices, bills of lading or any other source documentation. Furthermore, records obtained from the common carriers indicated that very few sales were shipped out of state, while a substantial number of shipments were to locations in California. The audit resulted in substantially underreported taxable sales but CDTFA staff concluded that there was insufficient evidence to impose a penalty for fraud. However, given the significant understatement, the records from common carriers, and the complete lack of source documentation, staff recommended that a 10 percent negligence penalty be added to the audit determination.

Example 5

Mr. Smith is a CPA whose practice, for the last three years, has involved advising and assisting business owners, including numerous restaurants, regarding best practices in running their businesses and record keeping and assisting them in preparing sales and use tax returns. Mr. Smith decided to close his CPA practice and open a sushi restaurant, something he always dreamed of doing. In the first audit of Mr. Smith's restaurant, staff found that Mr. Smith had failed to keep complete purchase invoices, had no guest checks or z tapes, and did not keep records showing any cold food sold "to go." However, Mr. Smith reported 30 percent of his sales as exempt sales of cold food "to go." The audit resulted in a substantial liability involving both unreported total sales and unsupported claimed exempt sales of cold food "to go." Although this was Mr. Smith's first audit, staff included a 10 percent negligence penalty because of Mr. Smith's extensive experience with the record keeping and reporting requirements for restaurants.

CLASSES OF NEGLIGENCE**0506.45**

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

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

NEGLIGENCE IN KEEPING RECORDS**0507.00****GENERAL****0507.05**

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

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

Complete absence of records will constitute strong evidence of negligence. However, auditors should determine if there are mitigating circumstances for the lack of records (see AM section 0507.50). Where records are maintained and a tax deficiency results, various factors must be taken into consideration in determining whether the tax deficiency was due to negligence in keeping records. The term “records” as used herein includes not only those specifically mentioned in Regulation 1698, but also such supporting data as resale certificates, shipping documents in support of interstate transactions, etc.

TEST FOR NEGLIGENCE IN KEEPING RECORDS**0507.10**

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

RECORDS NEED ONLY BE ADEQUATE FOR TAX PURPOSES**0507.15**

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

RECORDS NEED ONLY BE ADEQUATE FOR TYPE OF BUSINESS**0507.20**

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

NEGLIGENCE OF OTHER TAXPAYERS — NO EXCUSE**0507.25**

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

EFFECT OF LACK OF KNOWLEDGE ON PART OF TAXPAYER**0507.30**

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

ERRORS IN KEEPING RECORDS**0507.35**

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

ERRORS DO NOT NECESSARILY CONSTITUTE NEGLIGENCE**0507.40**

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

CONSIDERATIONS IN CLASSIFYING ERRORS**0507.45**

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

- a. The frequency of the errors relative to the volume of transactions. The number of errors found must be considered in relation to the total number and dollar amount of the same type of transaction in the audit period.
- b. The ratio of understatement to reported amounts. This percentage of error may be used in a variety of ways. For mark-up audits, the most appropriate evaluation is the ratio of understatement to reported taxable measure, particularly when reported taxable sales have been impeached. For audits where taxable measure is based on a percentage of total sales or claimed deductions, the most appropriate evaluation is the measure of understatement to total reported sales or claimed deductions. For both methods, a large ratio of understatement may be indicative of negligence. If the audit measure is derived from a statistical sample, comparison of the error percentage in the prior audit may be appropriate if the same items are being sampled. A substantive increase or comparable error percentage may be indicative of negligence. However, it must be noted that a ratio of understatement is not, in and of itself, proof of negligence. A ratio should be considered in conjunction with other factors to determine whether negligence has occurred.
- c. The cause of errors found by audit. The cause of errors may result from procedural or operational problems unrelated to negligence. For example, significant changes in sales volume from a prior audit may cause errors that result from staffing problems rather than negligence. Similarly, a business with a large volume of small dollar transactions may find it infeasible to hire the level of staff that would result in the total elimination of errors.

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

DESTRUCTION OF RECORDS

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

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

Records Accidentally Destroyed

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

Records Intentionally Destroyed

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

NEGLIGENCE IN PREPARING RETURNS **0508.00****DEFICIENCY DUE TO MISUNDERSTANDING** **0508.05**

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

TEST FOR NEGLIGENCE IN PREPARING RETURNS **0508.10**

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

MECHANICAL ERRORS **0508.15**

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

ERRORS IN APPLICATION OF LAW **0508.20**

Erroneous application of the Sales and Use Tax Law when completing returns does not constitute negligence unless there is evidence that the taxpayer failed to exercise due care in determining whether the transactions in question are subject to tax. The taxpayer may be regarded as having exercised due care if the taxpayer has acted in good faith and has made a reasonably diligent effort to determine how the tax applies to the taxpayer's business. The average taxpayer can only be expected to exercise the amount of diligence due from an ordinary prudent businessperson.

DUTY TO MAKE INQUIRY **0508.25**

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

EFFECT OF ERRONEOUS INFORMATION **0508.30**

A taxpayer who was misinformed about the proper application of tax may be relieved from the payment of tax, interest and penalty if the taxpayer meets the requirements for relief under RTC section 6596 (AM sections 0105.00 — 0105.10). If the taxpayer does not qualify for RTC section 6596 relief, the negligence penalty should not be warranted if the taxpayer provides evidence that the taxpayer contacted the CDTFA to inquire about the proper application/reporting of tax and was misinformed by CDTFA staff. However, the taxpayer remains liable for the applicable tax and interest.

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

PENALTIES

FAILURE TO REPORT PURCHASES SUBJECT TO USE TAX

0508.35

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

MORE THAN ONE LOCATION

0508.40

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

OTHER TYPES OF NEGLIGENCE

0508.45

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

WORKING PAPERS ARE DESTROYED

0508.50

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

EVASION PENALTIES**0509.00****GENERAL****0509.05**

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

The RTC sections that impose evasion penalties are as follows:

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

DEFINITION OF EVASION PENALTIES**0509.10**

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

EVASION VS. NEGLIGENCE PENALTIES**0509.15**

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

CONDITIONS WARRANTING AN EVASION PENALTY**0509.20**

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

EVIDENCE OF EVASION

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

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

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

BURDEN OF PROOF

As a matter of law, fraud is never presumed but must be proven and the burden of proof is on the CDTFA. However, the standard of proof is not beyond a reasonable doubt as in a criminal prosecution. (See *Helvering v. Mitchell* (1938) 303 U.S. 391). Instead, the standard of proof in civil tax fraud cases is “clear and convincing evidence” (In re *Renovizor’s Inc. v. BOE* (9th Cir. 2002) 282 F.3d 1233). “Clear and convincing evidence” requires evidence so clear as to leave no substantial doubt as to the truth of an assertion of fraud. That is, there is a high probability that the assertion of fraud is true.

A taxpayer’s intent to evade the tax is the key element to proving fraud. The mere fact that a taxpayer has a substantial tax liability does not in and of itself prove intent. Rather the evidence must support intent. For example, a consistent pattern of underreporting may indicate evasion, particularly if there is no other explanation for the understatement. However, additional evidence (e.g., falsified records) must be provided to support fraud when the underreporting is random. In all cases where a fraud penalty is recommended, the administrator must submit evidence of a substantial nature that the taxpayer knowingly committed specific acts with the intention of defrauding the State of tax, which was legally due. (See AM section 0509.75.)

EVASION BY AGENT, PARTNER OR EMPLOYEE**0509.40**

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

AMOUNT TO WHICH PENALTY APPLIES**0509.45**

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

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

KNOWINGLY OPERATING WITHOUT A PERMIT**0509.50**

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

RTC section 7155 imposes a 50 percent penalty of the tax due when a person, for the purpose of evading the payment of tax, *knowingly* fails to obtain a seller's permit. This penalty may be assessed when all of the following factors are present:

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

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

MISUSE OF A RESALE CERTIFICATE

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

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

- The purchaser, who does not hold a seller's permit, issues a resale certificate with an erroneous seller's permit number or gives the valid number of a permit held by another person, or
- The purchaser's permit was closed out prior to the date of purchase, or
- The purchase, regardless of amount, is one of a series of purchases which were not intended to be resold by the taxpayer in the regular course of business, or
- The purchaser knowingly issued a resale certificate for personal gain or to evade the payment of the tax. In these cases, the penalty should normally be applied regardless of the amount of the purchase and whether or not the purchase is one of a series of intentional misuses of the purchaser's seller's permit privileges, or
- The purchaser has been advised either through prior audit(s) or other contact with CDTFA staff on the proper use of resale certificates and/or the application of tax to purchases made for their own use.

The penalty generally does not apply in the following situations:

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

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

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

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

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

Exhibit 1 is a sample letter to be issued to a purchaser who is purchasing tangible personal property that is unusual for the type of business the purchaser is engaged in. If we are not requesting that the purchaser provide support for a specific transaction, we should make our intent clear. As this letter is addressed to purchasers whom we suspect may be misusing a resale certificate, the tone must be explanatory.

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

Investigations and Audits

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

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

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

OUT OF STATE REGISTRATION OF VEHICLE, VESSEL OR AIRCRAFT

0509.60

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

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

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

PENALTIES

FAILURE TO REMIT SALES TAX REIMBURSEMENT OR USE TAX 0509.65

Revenue and Taxation Code (RTC) section 6597, *Penalty; tax reimbursement collected and not timely remitted*, imposes a 40 percent evasion penalty on any person who knowingly collects sales tax reimbursement (Regulation 1700, *Reimbursement for Sales Tax*⁸) or knowingly collects use tax, and fails to timely remit that sales tax reimbursement or use tax (tax) to the CDTFA.

The penalty may only be applied when both of the thresholds listed below are met:

1. The liability for the unremitted sales tax reimbursement or use tax averages over \$1000 per month for the reporting period, and
2. The total unremitted tax exceeds five percent of the total amount of tax liability for which tax reimbursement was collected in the same quarterly reporting period in which the tax was due.

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

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

When the 40% evasion penalty is recommended for a portion of a deficiency determination, the 25 percent evasion penalty pursuant to RTC section 6485 should be applied to the remainder of the determination. It is not appropriate to recommend a 10 percent negligence penalty (RTC section 6484) for the remaining portion of a deficiency determination when the 40 percent penalty is warranted for a portion of the determination. In very unusual cases, it may be inequitable to apply an evasion penalty to the entire deficiency determination. For example, a change in management during an audit period may have resulted in the discontinuance of fraudulent practices, or the reverse. In these rare cases, staff may split the audit and issue two deficiency determinations; one with the evasion penalty (or penalties) and one without (i.e., either the 10 percent negligence penalty or without any penalty). If splitting the audit into two determinations, staff must fully document the reason for the split in the fraud memo.

When a taxpayer provides an explanation for failure to remit the tax, it is the Administrator's responsibility to evaluate the explanation. The Administrator will evaluate the taxpayer's explanation to determine whether the person's failure to timely remit the tax was due to reasonable cause and or circumstances beyond the person's control, and occurred notwithstanding the exercise of ordinary care and absence of willful neglect. RTC section 6597 provides specific examples of what constitutes "reasonable cause or circumstances beyond the person's control." If the penalty is not applied, the auditor must document the taxpayer's explanation on Form CDTFA-414-A, Report of Field Audit or Form CDTFA-414-B, Field Billing Order.

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

⁸ Pursuant to RTC section 6597, sales tax reimbursement also includes any sales tax that is advertised, held out, or stated to the public or to any customer, directly or indirectly, that the tax or any part thereof will be assumed or absorbed by the retailer.

When an audit recommends the 40 percent evasion penalty, a memorandum is required from the Administrator to the Chief, Headquarters Operations Bureau for sales and use tax and the Chief, Audit and Carrier Bureau for special taxes and fees. See AM section 0509.75, *Approval of Evasion Penalties*, for more information on this memorandum.

Procedures to Process Requests for Relief of Section 6597 Penalty

General

The Administrator, who recommended the imposition of the section 6597 penalty, reviews the relief request and either denies or makes a recommendation to grant the relief. However, when a taxpayer requests relief of the section 6597 penalty on an appealed liability, the request is handled through the normal appeals process.

Relief Requests

Requests for relief of penalty may be submitted online using the CDTFA's online services or in paper. The Petitions Section will forward all such requests for relief to the office that recommended the imposition of the 6597 penalty. See Compliance Policy and Procedures Manual (CPPM) section 535.075.

Review of Online Relief Requests

The Administrator is responsible for reviewing the relief request within 30 days of the referral and determining if the taxpayer's failure to timely remit sales tax reimbursement or use tax was due to reasonable cause or circumstances beyond the taxpayer's control as provided in RTC section 6597.

Relief Request Denied

When the Administrator recommends denial of the relief request, the Administrator must inform the taxpayer in writing of the denial and forward a copy to the Petitions Section mailbox. The assignment should be reassigned back to Petitions Section in the system to finalize the online penalty request. No further approval is required for a denial.

Relief Request Granted

When the Administrator recommends relief be granted, the recommendation must be forwarded to the Petitions Section mailbox to obtain approval by the Deputy Director, BTFD as provided by Audit Manual section 0501.30. The assignment should be reassigned back to the Petitions Section in the system to finalize the online penalty.

NOTE: If a recommendation is made to grant relief of a section 6597 evasion penalty, that in effect is a finding there was no fraud and thus the section 6597 penalty should not have been imposed. As explained in AM section 0509.70, the application of evasion penalties can extend determinations beyond the three or eight-year statute of limitations set forth in RTC section 6487 or ten-year statute of limitations set forth in RTC section 7073(d). Thus, in situations where a section 6597 evasion penalty was imposed and tax was assessed in the audit for periods beyond the normal statute of limitations, if a request for relief of penalty is granted, the tax assessed for the extended periods must be removed from the assessment. This is because the granting of the relief is a finding the penalty should not have been imposed and the tax assessed for periods beyond the normal statute of limitations must be removed.

MULTIPLE PENALTIES

Two or more fraud or evasion penalties may not be added to the same deficiency determination when the penalties apply to the same series of acts or course of action in the same reporting periods.

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

However, under certain circumstances, more than one penalty may apply to the same determination:

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

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

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

STATUTE OF LIMITATIONS FOR EVASION PENALTIES

The application of evasion penalties can extend determinations beyond the three or eight-year statute of limitations set forth in RTC section 6487 or ten-year statute of limitations set forth in RTC section 7073 (d) . Therefore, tax can be assessed and penalties imposed for prior periods in which the taxpayer intentionally understated the tax liability. However, proof that the taxpayer intentionally understated the tax liability within the otherwise applicable statute of limitations (three, eight or ten years) is not by itself sufficient to support an evasion penalty for periods outside the statutory period. Ideally, evasion should not be asserted for periods outside the applicable statutory period (three, eight or ten years), unless records for the expired periods are available, and such records establish an actual tax liability and support the assertion of fraud.

Where evasion was not disclosed in the audits of prior periods but discovered in a subsequent audit, the prior periods will be included in the subsequent audit if the following conditions are met:

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

APPROVAL OF EVASION PENALTIES**0509.75**

When an audit recommends an evasion penalty, a memorandum is required from the Administrator to the Chief, Headquarters Operations Bureau for sales and use tax and the Chief, Audit and Carrier Bureau for special taxes and fees. Upon the approval of the Administrator or someone acting on his or her behalf, and after the completion of audit review, the memorandum along with the audit case folder are sent electronically to the Chief, Headquarters Operations Bureau or Audit and Carrier Bureau for approval. See AM section 0213.12 for instructions on electronically submitting memorandums and audits recommending evasion penalties. This information is also available on the Headquarters Operations Bureau iCDTFA page under “Approve Fraud Penalty Requests”. A copy of the respective memorandum is also sent to the Deputy Director, Field Operations Division or the Deputy Director, Business Tax and Fee Division. *The taxpayer may not be furnished a copy of the memorandum until the Chief, Headquarters Operations Bureau, or the Chief, Audit and Carrier Bureau, has approved the evasion penalty.*

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

In addition, auditors should consider the following elements when preparing a memorandum recommending an evasion penalty:

- The memorandum:
 - Should stand alone and include all relevant information for the penalty recommendation. Attach any information, audit schedules, or other documentation (such as letters, emails, or statements) that are referenced in the memorandum.
 - Should include the phrase “clear and convincing evidence” when explaining the reason for the evasion penalty recommendation.
 - Must specifically describe the evidence staff believes is clear and convincing evidence of taxpayer’s intent to evade the taxes due.
 - Should include a discussion of why the evasion penalty instead of the negligence penalty is appropriate.
 - Should include tables, reconciliations, charts, etc., that support the evasion penalty recommendation as these may provide good visual guides to the errors and discrepancies.
- Use the term “evade” or “intent to evade” rather than fraud, when possible.

PENALTIES

APPROVAL OF EVASION PENALTIES

(CONT.1) 0509.75

Following are suggested headings and examples of relevant information to include in memorandums recommending an evasion penalty. These suggestions are meant to provide guidance and may be used as an instructional tool. Staff may modify the headings and add any additional information as needed.

Introduction (example of an opening paragraph):

We recommend application of the 25% penalty per RTC section 6485, for Taxpayer, during the period xx/xx/xx to yy/yy/yy. We believe the evidence described below establishes by clear and convincing evidence that the tax deficiency is the result of a deliberate intent to evade the payment of tax.

If multiple penalties are recommended, separately list all penalties and the applicable periods. If the penalties have specific requirements in addition to clear and convincing evidence of an intent to evade the tax, such as the 40% penalty, the opening paragraph should also address those requirements.

Business Operations

Summarize the business operations, hours of operations, and any other relevant information.

Audit Investigation

Summarize the taxpayer's recording and reporting method, types of books and records provided, the audit methodology, and the results of the audit investigation.

Describe the taxpayer's involvement in the business, for example, if the taxpayer was involved in the day to day business operations, placed orders, purchased inventory, paid vendors, recorded transactions, or prepared the sales and use tax returns, etc. Describe the taxpayer's knowledge of the law and/or reporting requirements; such as, the length of time the taxpayer has been in business, prior permits, prior audits (with or without similar errors), letters to and from the CDTFA, the system documentation of communications with the taxpayer, questionnaires or statements from the taxpayer or others involved with the business, such as employees, bookkeepers, and accountants, and CDTFA publications or other information previously provided to the taxpayer.

Evidence Supporting Fraud

The memorandum must clearly describe all the evidence from the audit investigation that supports the taxpayer's intent to evade the payment of tax (see AM section 0509.10 for the definition of fraud). The evidence should include any direct evidence of fraud and/or circumstantial evidence that indicates a deliberate attempt to evade the payment of tax. In most cases, it will be necessary to rely primarily on circumstantial evidence to show that taxpayer's failure to pay was a deliberate attempt to evade the payment of tax. Evidence that may establish that taxpayer's failure to follow the law was done with the intent to evade the tax may include, but is not limited to:

- Falsified records and/or more than one set of records.
- Substantial and pervasive underreporting.
- Failure to pay substantial tax reimbursement collected from customers.
- Improbable or inconsistent explanations for the underreporting.
- Misrepresentations or other efforts to conceal the correct tax liability.
- Use of multiple bank accounts to conceal income.
- Evidence of improper transfers of unreported tax reimbursement.

Any assertion of an intent to evade the tax must be supported by as many of the above indicators as possible. Any indicator of evasion must be documented to the extent possible. Findings of substantial discrepancies and proper charging of tax or tax reimbursement are generally *not*, in and of themselves, enough to establish an intent to evade. Other evidence of taxpayers' intent to evade the tax *must* be included in the memorandum.

Intent to evade must generally be established by evidence that the taxpayer knew that the taxes at issue were due and that the taxpayer's failure to pay was deliberate and for the purpose of evading the tax (as opposed to a lack of funds). Evidence that may be used to establish knowledge of the law includes, but is not limited to:

- Taxpayer's length of time in business.
- Taxpayer's prior operation of other, similar businesses as evidenced by prior permits held by the taxpayer.
- Prior audits, letters, or other written advice received from the CDTFA.
- Taxpayer's personal involvement in the day to day operation of the business, including but not limited to the preparation of returns.
- Accurate calculation of tax on taxable sales, including charging the correct amount of district taxes.
- Otherwise accurate recordkeeping of sales.
- Accurate reporting of sales on returns filed with other agencies, such as income tax returns.
- Prior statements by the taxpayer or other employees regarding knowledge of the applicable tax laws.
- Evidence of communications with accountants or bookkeepers regarding the correct reporting of taxable sales.

Always ask the taxpayer for an explanation of the errors/discrepancies that led to the recommendation of the evasion penalty and include the taxpayer's explanation in the memorandum. As explained above, an improbable or inconsistent explanation may be evidence of the taxpayer's intent to evade the tax. If the taxpayer has no explanation for the errors, document this in the memorandum as well.

The memorandum should always include an explanation of how the taxpayer benefited by evading the payment of tax. For example, by not reporting all recorded taxable sales, the taxpayer has benefited monetarily by retaining the tax collected from their customers. Or, by evading the payment of tax, the taxpayer was operating at a competitive advantage over others in the same business.

Include any tables, reconciliation, charts, etc., in the memorandum that support the penalty recommendation. Attach copies of all documents that are referenced in the memorandum. Documentation that may support an evasion penalty include audit schedules, copies of falsified records, prior audit reports, CDTFA letters or other publications providing specific advice, copies of previous permits and applications, evidence of improper transfers of unreported tax, and letters or notes between taxpayer and employees or agents.

PENALTIES

APPROVAL OF EVASION PENALTIES

(CONT.2) 0509.75

RTC Section 6597, Penalty

RTC section 6597 imposes a 40 percent evasion penalty on any person who knowingly collects sales tax reimbursement or knowingly collects use tax, and fails to timely remit that sales tax reimbursement or use tax (tax) to the CDTFA. If recommending the 40 percent evasion penalty under RTC section 6597, in addition to establishing, by clear and convincing evidence, the taxpayer's intent to evade tax, staff should state and explain how all conditions listed in AM section 0509.65 for applying the 40 percent penalty are met. The inclusion of a table of quarterly tax collected and tax reported to illustrate that the conditions listed in AM section 0509.65 are met is recommended.

Staff should also include the following information (if applicable) in the memorandum when recommending the 40 percent penalty:

- A description of the activity (including any unusual activity) in the taxpayer's tax accrual account that would indicate an intent to evade the tax.
- Detail of the debits/credits from the tax accrual account including dates and amounts.
- If the taxpayer does not maintain a tax accrual account, then an explanation from the taxpayer as to what happened to the tax collected is required.
- Any additional information obtained that supports the 40 percent penalty.

Summary and Recommendation

Summarize why the evasion penalty is recommended and include a discussion of why the imposition of the evasion penalty is appropriate instead of a negligence penalty. For example, prior business experience and/or otherwise accurate recordkeeping, combined with substantial, repeated, and unexplained error rates and/or understatements, improbable and/or inconsistent explanations, falsified records, etc., all are evidence of an attempt to evade that is not merely the result of negligence.

The following provides an example of a concluding paragraph:

The taxpayer was aware of the laws regarding the proper reporting of taxable sales as evidenced by his/her prior business experience, advice received in prior audits, and otherwise accurate recordkeeping of sales, including the correct calculation of tax on taxable sales. Despite this knowledge, the taxpayer had consistent and material underreporting of taxable sales throughout the reporting period. The taxpayer failed to report substantial amounts of tax reimbursement collected on taxable sales. In addition, the taxpayer was personally responsible for the preparation of the sales and use tax returns and provided inconsistent and improbable explanations for the underreporting. The foregoing is evidence that the taxpayer's underreporting cannot reasonably be concluded to have been an act of mere negligence. The foregoing establishes by clear and convincing evidence that taxpayer failed to report the taxes due with the intent to evade tax and therefore the conduct is not merely negligent, but fraudulent.

In those cases where criminal tax evasion is suspected and potential prosecution is contemplated, the case should be referred to the Investigations Division through the Deputy Director, Field Operations Division or the Deputy Director, Business Tax and Fee Division. Criminal prosecution comments should be made only on the copy to the appropriate Deputy Director.

MISCELLANEOUS 0510.00**FAILURE TO OBTAIN EVIDENCE THAT OPERATOR OF CATERING TRUCK HOLDS VALID SELLER'S PERMIT 0510.05**

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

FAILURE OF RETAIL FLORIST TO OBTAIN PERMIT 0510.10

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

PENALTIES IN BANKRUPTCY CASES 0510.20

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

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

RECEIVERS, TRUSTEES AND DEBTORS IN POSSESSION 0510.25

Trustees of bankruptcy estates and debtors-in-possession may operate the business of a debtor. Accordingly, penalties which attach by reason of the delinquency or malfeasance of a trustee, or debtor-in-possession while operating a business will be billed to the trustee, debtor-in-possession, and bankruptcy estate.

NEGLIGENCE AND EVASION PENALTIES — DECEASED TAXPAYERS 0510.30

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

NEGLIGENCE AND EVASION PENALTIES — DEATH OF PARTNER 0510.35

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

ASSIGNMENT FOR THE BENEFIT OF CREDITORS 0510.40

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

PENALTIES
TABLE OF EXIHIBITS

Sample Warning Letter — Misuse of a Resale Certificate.....	Exhibit 1
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Examples — Application of 40 Percent Penalty	Exhibit 3

Sample Warning Letter — Misuse of a Resale Certificate

Exhibit 1

Date

ABC Company
One Main Street
Sacramento, CA 95814

In Reply Refer To:
Account number

Dear Mr. Jones:

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

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

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

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

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

Sincerely,

PENALTIES

Sample Letter Imposing Penalty for Misuse of a Resale Certificate Exhibit 2

Date

ABC Company
One Main Street
Sacramento, CA 95814

In Reply Refer To:
Account Number

Dear Mr. Jones:

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

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

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

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

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

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

Sincerely,

Enclosure: CDTEFA-1, *Audit Payment Information*

Examples — Application of 40 Percent Penalty**Exhibit 3**

The following examples illustrate whether the penalty is applicable.

Example 1

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

Example 2

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

Example 3

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