



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

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September 28, 2016

VIA INTERNET

Dear Interested Party:

The Audit Manual (AM) is a guide for the Board of Equalization (BOE) staff in administering tax and fee programs. It is available to the public and can be accessed from the BOE web page at <http://www.boe.ca.gov/sutax/staxmanuals.htm>.

The Business Tax and Fee Department (BTFD) is proposing to revise AM Chapter 4, *General Audit Procedures* and AM Chapter 9, *Grocers*, to incorporate current policies and procedures. The revision material is provided on the following pages for the convenience of interested parties who may wish to submit comments or suggestions. Please feel free to publish this information on your website or otherwise distribute it to your association/members.

If you have any comments or suggestions related to the proposed AM revisions, you may contact the BOE at AM.RevisionSuggestions@boe.ca.gov. Your comments or suggestions must be received by BOE no later than **November 28, 2016**, in order to be considered by staff. Thank you for your consideration.

Sincerely,

Chief, Tax Policy Division
Business Tax and Fee Department

Audit Manual Chapter 4, *General Audit Procedures*

MARK-UP METHODS

0407.10

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

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

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

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

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

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

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

MARK-UP OF COST OF EXEMPT FOOD ITEMS

0407.12

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

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

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

AUDITS OF SALES SUBJECT TO USE TAX

0408.12

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

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

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

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

[While these steps must be taken to ensure tax is not asserted more than once on a single transaction, the auditor must also maintain the confidential nature of BOE's information and not disclose to the taxpayer that the other party is under audit or that the BOE intends to examine the records of the other party. To ensure confidentiality, the auditor should only comment in the audit work papers that “tax has otherwise been paid.”](#)

[Out-of-state retailers are required to register and collect use tax on sales made to customers in this state if they are “engaged in business” in this state. If the out-of-state sellers cannot be found in IRIS, it is likely they are not registered with the BOE and the auditor is to prepare a BOE-1164, *Audit Memorandum of Possible Tax Liability*, form as provided in AM section 0408.19.](#)

[Following are examples of transactions in which auditors need to verify whether use tax was paid by or assessed in the audit of the corresponding purchaser or seller.](#)

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

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

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

When the auditor establishes the seller is registered with the BOE with a seller's permit or a certificate of registration for use tax, the auditor should use IRIS jump code AUD MC to determine whether the questioned transaction occurred during an audit of the seller.

If the transaction does occur within an audit period of the seller, then the auditor should determine if any use tax assessment was made against the seller. This can be done by:

- Contacting the auditor of the seller directly and/or
- Reviewing the audit in the Audit Archive

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

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

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

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

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

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

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

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

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

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

**BAD DEBTS INCURRED BY LENDERS ON
PURCHASED ACCOUNTS RECEIVABLE**

0419.17

Reserve Accounts: In the case of a loan purchased by a lender from an automobile dealer who sold a vehicle at retail and reported tax on that sale, often, to offset any losses that may be incurred by the lender as a result of a purchase/borrower's default on the loan, the lender remits a portion of the principal to the dealer and retains the remainder in a reserve account. "Principal" refers to the proceeds of the sale of the loan from the dealer to the lender. The remaining principal in the reserve account typically is transferred by the lender to the auto dealer within one to three months after the transaction date.

When an auto loan sold to a third-party lender becomes uncollectible, the lender typically charges the reserve account for some or all of the outstanding balance that the purchaser/borrower failed to pay on the loan. In such circumstances, the loan is considered to be sold with recourse. The amount charged to the reserve account represents a reduction in the amount of gross receipts from the original sale of the automobile.

If a loan was sold with recourse, Regulation 1642, *Bad Debts*, subdivision (h)(1)(C), provides that the auto dealer may be entitled to claim a bad debt deduction or refund to the same extent as if the loan had not been sold. In the reserve account scenario, the amount of the bad debt loss is measured by the amount of the reduction to the lender's reserve account with respect to the unpaid amount upon which tax has been paid. However, the allowable bad debt deduction would exclude any nontaxable receipts, such as, amounts allocable to interest, insurance, repair or installation labor as provided in Regulation 1642, subdivision (b).

Audit Manual Chapter 9, Grocers

SALES OF FOOD PRODUCTS FOR HUMAN CONSUMPTION

0904.15

Grocers may use any method they choose to compute the amount of [exempt](#) sales of food products for human consumption claimed on their sales tax returns. They must, of course, maintain adequate records to support the amount so claimed. Audit procedures for verifying this deduction are explained in subsequent sections. [For markup methods for businesses selling a minimal amount of exempt food items, see AM section 0407.12.](#)

One of the first steps in verifying the claimed exempt food deduction is to determine if the taxpayer correctly classified [the item as a food product and that the sale is exempt.](#) ~~s as taxable or nontaxable.~~ Listed below are some common food products sold by grocers and the tax application (see Regulations 1602 and 1603 for additional information).

NOTE: [Sales of taxable items \(such as soda\) purchased with CalFresh benefits \(see AM section 0904.30\) may be included in claimed exempt sales of food products by the taxpayer if they do not separately claim those sales as exempt sales to the U.S. Government.](#)

Taxable Food Products

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