This presentation is designed to help you avoid some of the most common sales and use tax mistakes.

The Board of Equalization maintains an effective audit program designed to ensure that businesses report neither more nor less tax than required. In fiscal year 2007-08, the sales and use tax audit program disclosed net deficiencies of more than $329 million and more than $116 million in sales and use tax refunds. In conjunction with the audit program and as part of the Taxpayer's Bill of Rights, the Board annually identifies the areas of the Sales and Use Tax Law where taxpayer non-compliance is highest. This information is published each year in the Board of Equalization's annual report.

Before detailing the areas of non-compliance, let us go over three of the basic aspects of the sales and use tax law.

The Sales and Use Tax Law provides that all sales are taxable, unless the law provides a specific exemption or exclusion. The law provides that the person making the sale has the burden of proving that a sale is exempt from tax. Therefore, if an exemption does exist, the seller is required to support the exemption with proper documentation and retain this documentation for potential examination by the Board of Equalization.

This presentation will cover the basic areas of Sales and Use Tax noncompliance listed on the slide. The first two areas we will discuss include untaxed purchases from Out-of-State Vendors and Withdrawal from Resale Inventory for your Own Use.

As a seller of tangible personal property, you are entitled to purchase the items that you will resell without payment of tax. However, if you are purchasing consumable supplies that you are not reselling, such as paper or toner, fixed assets such as a copier, or other tangible personal property such as computer screen cleaner, you should pay the tax on those purchases. If you purchase these items from a retailer located outside of California that does not charge the California tax, you owe California use tax on the purchase price of the property.

As stated previously, as a seller of tangible personal property, you are entitled to purchase property that you plan to resell without payment of tax. However, if you remove items from resale inventory and make a use of the property rather than reselling the property, you owe tax on your purchase price of the property. For example, if you give away merchandise as a gift or use the property yourself, you owe tax on the purchase price of the property. Also, if you use resale inventory for marketing purposes or research and development, that is considered a use of the property and you owe tax on the purchase price of the property.

Reporting use tax is not limited to businesses. Individuals are also required to report purchases subject to use tax. Many consumers purchase items over the Internet from out-of-state retailers. If your business is a sole-proprietorship or a husband-wife partnership, you should report your individual purchases on your sales and use tax return. Otherwise, these transactions should be reported as purchases subject to use tax on a BOE individual use tax return or may be reported on your California income tax return.

Next we will discuss unsupported sales for resale. When you make a sale for resale, you should obtain supporting documentation from the purchaser. This typically consists of obtaining a resale certificate from the purchaser. It is important to keep your resale card file up to date, but also to retain old resale certificates. It's a good idea to maintain and update resale certificates periodically.

A resale certificate may be in any form, provided it contains all of the required elements. For a resale certificate to be complete, it must contain:
The purchaser's name and address
The purchaser's valid seller's permit number.
A description of the property being purchased.
A statement that the property being purchased is "for resale."
The resale certificate must be signed and dated by the purchaser.

If the purchaser does not have a seller's permit number, the purchaser should indicate a valid reason why they do not have a seller's permit. Although not required, it is generally a good idea to also include the purchaser's type of business activity, the title of the person signing the resale certificate, and the name of the seller.

If you wish to verify the seller's permit number included on the resale certificate as valid or not, you may call our toll-free number at 888-225-5263 or access our website.

As the previous slide explained, you may verify a seller's permit number on the Board of Equalization's website. This is what the Seller's Permit Verification screen will look like.

Resale certificates are available at many stationary stores. A sample resale certificate is also available on our website as form BOE-230 or in Regulation 1668 or publication 73. It is very important to remember that a resale certificate must be filled out completely, taken timely, and in good faith. To be considered taken timely, the completed resale certificate must be obtained prior to delivery of the property or within the seller's normal billing cycle, whichever is later.

A seller is presumed to have taken a resale certificate in good faith unless there is evidence to the contrary. If the purchaser insists that the purchaser is buying items for resale that are not normally resold in the purchaser's business, the seller should require a resale certificate containing a statement that the specific property is being purchased for resale.

This sample resale certificate, form BOE-230, is available on the BOE website. You may find it under the "forms and publications" tab or searching by form number.

As provided previously, a resale certificate may be in any form, provided it contains all of the required elements. Many purchasers utilize a purchase order when purchasing property. Provided the purchase order contains all of the required elements, the purchase order may be used as a resale certificate. It is important to note the language used on the purchase order must state "for resale" and may not use alternate language such as exempt, not-taxable or some other language.

Some purchasers utilize a combination of a resale certificate and a purchase order. The resale certificate will contain all of the required elements except for a description of the property. Under the description of the property, it will provide "see purchase order." Each purchase order will then indicate whether each individual purchase is taxable or for resale. In this case, both the resale certificate and the purchase together make a valid resale certificate and both documents must be retained by the seller to support a claimed sale for resale.

Beware of the situation where a purchaser tells you a purchase is for resale and instead of providing you with a valid resale certificate, provides you with a copy of their seller's permit. A copy of the seller's permit only shows that the person is engaged in business in this state and does not shift the liability for the tax to the purchaser. Only by obtaining a valid resale certificate will the liability for the tax be shifted to the purchaser.

Misuse of a resale certificate is a misdemeanor. If a purchaser is found to have issued a resale certificate for property that was not purchased for resale, the purchaser is subject to a penalty of $500 or 10% of the amount of tax, per transaction. For example, if an audit of a purchaser discloses three different purchases totaling $2,000, the purchaser would be subject to a penalty of $1,500 in addition to the tax due on the purchase price of the property.

The difference between recorded and reported taxable sales can be an issue in some audits. As part of any examination of your books and records, a tax auditor will compare the taxable sales you have recorded in your books and records and taxable sales you have reported on your return. There are valid reasons for differences, depending on how you keep you books and records. For example, if you have claimed a bad debt on a taxable sale, returned taxable merchandise, or tax paid purchases resold prior to use, the amount of taxable sales recorded in your books and records may be different than the taxable sales reported on your return. It is recommended that you make a periodic comparison between your recorded and reported taxable sales. If there are any differences due to valid reasons, you should make a note in your records regarding such a difference.

Sometimes auditors will find it necessary to evaluate a business' sales by use of the markup method. The next series of slides show you a way to check your records.

With cash based businesses, such as grocery stores, liquor stores, and restaurants, there is a potential for sales to be understated due to a number of reasons. Therefore, as part of an examination of your books and records, the auditor will generally perform a markup analysis. This involves comparing your cost of goods sold with your reported sales to calculate a markup per your records. A markup is then computed based your current purchase invoices and your selling prices for these same items. This is often referred to as a shelf test, since the selling prices for the items on the shelves are used. The markup per your records is compared with the markup from the shelf test to determine if further analysis is necessary.

To compute the markup based on your records, take the difference between your recorded sales and your cost of goods sold. This difference is your gross profit. Then divide your gross profit by your cost of goods sold to calculate your markup. In this example, the markup per the recorded sales was 33.33%. The results of the shelf test would indicate to the auditor whether the total sales figure reported to the Board was correct.

This is an excellent tool you may use to determine if your total sales were reported correctly. Gross profit divided by cost of goods sold is the markup, and a good indicator as to whether total sales and or cost of goods are consistent, and whether additional work needs to be done to resolve any discrepancies.

If the markup is considered low for the type of industry it may be necessary to develop a true markup from a shelf test and apply the mark-up to the cost of goods sold. The result of audited total sales is compared to the total sales reported.

For example, Joe, the grocery store owner, reports $100,000 in total, both taxable and nontaxable merchandise sales. His cost of goods sold were $75,000, and the resulting markup percentage is 33.33%. The mark-up percentage was calculated by taking your total sales and subtracting the cost of good sold and dividing that quantity by the cost of goods sold. This mark-up may be found to be accurate and an indicator to the auditor that all of Joe's sales reported on Line 1 of the Sales and Use Tax return were accurate.

For a retailer that sells both taxable and non-taxable merchandise, such as a grocery store, the markup for both taxable and non-taxable must be examined separately. This helps an auditor determine if reported sales are accurate. While a business owner may have reported all of his or her sales, errors such as ringing a taxable sale into the cash register as a nontaxable food product can reflect a low markup of taxable merchandise. As we discussed in the previous slide, you take the taxable sales minus the taxable Cost of Goods Sold and that equals the Gross Profit. Then you take the Gross Profit and divide it by the taxable Cost of Goods Sold.

In this example Joe reported $33,000 as taxable sales and he reported the other $67,000 as nontaxable sales of food products.

Per the examination of Joe's records, Al, the auditor, determines that the Cost of Goods Sold of taxable merchandise was $30,000. Therefore, using the formula described previously, Al plugs in the taxable sales reported of $33,000 and the Taxable Cost of Goods Sold of $30,000 and the result is a 10% markup which indicates that not all taxable sales were reported.

With further examination of Joe's records, Al determines that the Cost of Goods Sold of the nontaxable food merchandise was $45,000 Using the same formula, Al plugs in the exempt sales reported of $67,000 and the Exempt Cost of Goods Sold of $45,000, and the result is a 49% markup which is significantly higher than what is expected. This would indicate that some taxable sales are being rung up on the non-taxable key or scanned incorrectly.

To figure out the correct taxable mark-up, Al conducts a shelf test and determines the taxable mark-up for Joe's store is 30%. He concludes that Joe did not report his taxable sales correctly, which we previously concluded was from ringing up or scanning items incorrectly. To determine the correct amount of taxable sales, the auditor will then apply the 30% mark-up to the Taxable Cost of Goods Sold, which in this case is $30,000.

That application will result in a total of $39,000 in audited taxable sales. The difference between calculated taxable sales and the reported taxable sales would be assessed in the audit by Al, which is $6,000. Joe will owe tax on the $6,000 difference depending on the tax rate at the location of his store. As this example illustrates, it is very important to maintain accurate books and records not only for your sales, but also for your purchases.

Sometimes the difference between tax accrued and tax paid can be an area where problems occur. Generally, a business that utilizes a double-entry set of accounting records will have a sales tax accrual account. As the business collects sales tax reimbursement from its customers, an entry is made in the sales tax accrual account to record the liability to the state. As part of the examination of your books and records, the tax auditor will reconcile the amounts posted to the sales tax accrual account with the sales tax reported to the state. If your records disclose a difference between the total amount accrued or collected and the total amount paid, the auditor will want to know why, and you may be liable for any unexplained differences. Although you are not required to maintain a double entry set of accounting records with a sales tax accrual account, it is a good idea to examine the amount of sales tax reimbursement collected from customers with amounts reported on your sales and use tax returns.

Inadequate Records may result in Unreported Sales. What are considered adequate records for one business may not be adequate for another. Therefore, there is no specific list of what each business must maintain to be considered adequate. It's generally recommended that source documents, such as cash register tapes or sales invoices, along with summary journals, such as a sales journal, be maintained to document sales. For purchases, purchase invoices, cancelled checks, purchase orders, and a purchase journal should be maintained. If you are claiming any sales as exempt from tax, you must maintain supporting documentation for the claimed exemptions. For example, you should retain resale certificates, shipping documents, or exemption certificates to support your claimed exempt sales. If you use any kind of worksheet in preparing your return, you should retain a copy of the worksheet. It is important that you retain your books and records for a period of at least four years.

Unsupported Sales in Interstate Commerce is another common noncompliance issue. Sales in interstate commerce are generally exempt from California sales tax. Sales tax does not apply when the property pursuant to the contract of sale is required to be shipped and is shipped to a point outside this state by the retailer, by facilities operated by the retailer, or by common carrier. Supporting documentation such as the contract of sale, bill of lading, freight invoice, or delivery receipt should be retained as support for the claimed exemption.

If the out of state purchaser takes delivery of property in California, the sales tax exemption does not apply, even if the purchaser subsequently takes the property out of state. This is true even if the goods are intended to be shipped out of state, but are diverted to a location in California while in transit. It's important to note the ship-to address, not the bill-to address. This is commonly found on drop shipment transactions where the purchaser is located outside California, but the purchaser is requesting that the property be drop shipped to their customer in California. Since delivery is taking place in California, this transaction does not qualify as exempt from tax as a sale in interstate commerce.

Our service representative are available to assist you during regular business hours Monday through Friday.

When you have exhausted all other avenues, the Taxpayers' Rights Advocates office is available to step in and help you. They can also explain more about your rights under the law.

If you are interested in participating in a voluntary taxpayer educational consultation, you may contact your local BOE office to make an appointment. This free one-on-one consultation allows a BOE representative to review your business operations, books and records, and determine whether your records are adequate and if you are reporting your sales correctly.

Thank you for taking the time to listen to this presentation. We wish you success in your business venture.