

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:
M. FAROOQUI

) OTA Case No. 19034564
) CDTFA Account No. 101-610773
) CDTFA Case ID 872279
)
)

OPINION

Representing the Parties:

For Appellant:

Juan Guzman, CPA

For Respondent:

Randy Suazo, Hearings Representative
Christopher Brooks, Tax Counsel IV
Jason Parker, Chief of Headquarters
Operations

For Office of Tax Appeals:

Deborah Cumins,
Business Taxes Specialist III

K. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, M. Farooqui (appellant) appeals a decision issued by the respondent California Department of Tax and Fee Administration (CDTFA)¹ in response to appellant's timely petition for redetermination of a Notice of Determination (NOD) for a liability of \$99,090.41 tax, a negligence penalty of \$9,909.04, and applicable interest, for the period January 1, 2011, through June 30, 2014 (audit period). In its subsequent decision, CDTFA deleted the negligence penalty and denied the remainder of the petition.

Office of Tax Appeals Administrative Law Judges Keith T. Long, Andrew Wong, and Nguyen Dang held an oral hearing for this matter in Cerritos, California,² on

¹ Sales taxes were formerly administered by the State Board of Equalization (board). Effective July 1, 2017, functions of the board relevant to this case were transferred to CDTFA. (Gov. Code, § 15570.22.) When referring to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to its predecessor, the board.

² The oral hearing was noticed for Cerritos, California, and conducted electronically due to Covid-19.

September 23, 2020. At the conclusion of the hearing, the record was closed and this matter was submitted for decision.

ISSUE

Whether appellant has shown that adjustments are warranted to the audited amount of unclaimed bad debts.

FACTUAL FINDINGS

1. Appellant has operated a used car dealership in Victorville, California, since August 2010.
2. During the audit period, appellant reported total sales of \$3,532,536, claimed deductions totaling \$1,124,435 (including bad debt losses of \$59,900), and reported taxable sales of \$2,408,100.³
3. For audit, appellant provided federal income tax returns (FITRs) for 2011 and 2012, vehicle dealer jackets,⁴ a list of repossessed vehicles, repossession documents, purchase invoices for expenses related to vehicle repair and restoration, and Report of Sale (ROS) forms issued by the California Department of Motor Vehicles (DMV).
4. Appellant did not provide a contemporaneous summary record of vehicle sales (such as a sales journal). However, he did prepare a list of sales from the available dealer jackets.
5. CDTFA compared the sales that appellant recorded on the list of sales to the taxable sales that appellant reported to CDTFA and found unreported taxable sales of \$1,632,121. CDTFA then compared the sales recorded on appellant's list to the DMV's ROS data to compute additional unreported taxable sales of \$61,500.
6. CDTFA reviewed appellant's claimed bad debt deductions. Appellant did not claim any bad debt deductions on his FITRs for 2011 and 2012. Appellant claimed bad debt deductions of \$59,900 on his sales and use tax returns during the audit period. Based on discussions with appellant, CDTFA found that appellant did not claim bad debt deductions for every vehicle repossession. Instead, for some repossessions, appellant

³ We compute \$2,408,101 (\$3,532,536 - \$1,124,435). We presume the difference is due to rounding.

⁴ A vehicle dealer jacket is typically maintained by a used car dealer for each vehicle sale. The jacket includes the sales contract and any documents related to the sale.

subtracted the amount of the original sale from the amount of recorded taxable sales to establish the amount of reported taxable sales for the relevant quarter.

7. CDTFA reviewed appellant's repossession documents, which included a list of 137 repossessed vehicles and supporting documentation for 121 of these vehicles. CDTFA did not allow any deduction for unclaimed bad debts (hereafter, unclaimed bad debt deduction) for the 16 vehicles for which appellant provided no supporting documentation.
8. For the remaining 121 repossessed vehicles, CDTFA reviewed each transaction on an actual basis to determine whether appellant sustained a net loss, which would entitle him to an unclaimed bad debt deduction. For each transaction, CDTFA subtracted the wholesale value of the vehicle from the net contract balance at the time of repossession⁵ to determine whether appellant was entitled to an unclaimed bad debt deduction.⁶
9. CDTFA calculated the wholesale value of the 121 repossessed vehicles as follows:
 - For 42 vehicles that appellant resold, CDTFA reduced the vehicle's post-repossession resale price by the markup rate of 57.56 percent⁷ to estimate the wholesale value of the vehicle at the time of repossession.
 - For 25 vehicles for which there was no resale information, CDTFA reduced the vehicle's original sale price by the markup rate of 57.56 percent to estimate the wholesale value of the vehicle at the time of repossession.
 - For 3 vehicles with no sales information, CDTFA estimated the wholesale value of the vehicle based on values listed in the Kelley Blue Book.
 - For 46 vehicles, CDTFA determined that the wholesale value at the time of repossession was zero because the vehicle was either never returned or damaged beyond repair.
 - For 5 vehicles for which there was no resale information, CDTFA reduced the vehicle's original sales price by the markup rate of 57.56 percent to estimate the wholesale value of the vehicle at the time of repossession and found that the

⁵ The net contract balance equals the contract price plus accrued finance charges less payments received.

⁶ Here, appellant only disputes CDTFA's calculation of the wholesale value of each vehicle.

⁷ CDTFA calculated the book markup by comparing the gross receipts that appellant reported on its FITRs for 2011 and 2012 to the cost of goods sold that appellant reported on its FITRs for that same period.

wholesale value was greater than the net contract balance. CDTFA did not allow a bad debt deduction for these vehicles.

10. In total, CDTFA calculated unclaimed bad debts of \$472,049 for 116 vehicles.
11. Thus, CDTFA calculated an understatement of reported taxable sales of \$1,221,572 (\$1,632,121 difference between recorded and reported + \$61,500 additional sales based on a comparison with DMV records - \$472,049 unclaimed bad debts).
12. CDTFA also applied a negligence penalty of \$9,909.04 based on the difference between appellant's recorded taxable sales and appellant's reported taxable sales, which CDTFA determined was due to negligence.
13. On April 23, 2015, CDTFA issued the aforementioned NOD. Appellant filed a timely petition for redetermination, disputing only the amount of unclaimed bad debts. CDTFA issued a decision deleting the negligence penalty and otherwise denying the petition. This timely appeal followed.

DISCUSSION

The California sales tax is imposed on a retailer's retail sales of tangible personal property in this state, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, § 6051.) It is the retailer's responsibility to maintain complete and accurate records and to make them available for examination. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).) The retailer bears the burden of establishing its entitlement to any claimed deduction or exemption. (*Paine v. State Bd. of Equalization* (1982) 137 Cal.App.3d 438, 443 (*Paine*)).

A retailer is relieved from liability for sales tax that became due and payable, insofar as the measure of tax is represented by accounts that have become worthless and charged off for income tax purposes by the retailer or, if the retailer is not required to file income tax returns, charged off in accordance with generally accepted accounting principles. (R&TC, § 6055(a); Cal. Code Regs., tit. 18, § 1642(a).) If the worthless and charged off amount of an account is comprised in part of nontaxable receipts such as interest, insurance, repair, or installation labor and in part of taxable receipts upon which tax has been paid, a bad debt deduction may be claimed only with respect to the unpaid amount upon which tax has been paid. (Cal. Code Regs., tit. 18, § 1642(b)(1).)

When a retailer makes a repossession, a bad debt deduction is allowable only to the extent that the retailer sustains a net loss of gross receipts upon which tax has been paid. (Cal. Code Regs., tit. 18, § 1642(f)(1).) A net loss is sustained when the amount of all payments and credits allocated to the purchase price of the merchandise, including the wholesale value of the repossessed article, is less than that price. (*Ibid.*) In support of deductions for bad debts, retailers must maintain adequate and complete records showing: 1) the date of original sale; 2) the name and address of purchaser; 3) the amount the purchaser contracted to pay; 4) the amount on which the retailer paid tax; 5) the jurisdiction(s) where the local taxes and, when applicable, district taxes were allocated; 6) all payments or other credits applied to the account of the purchaser; 7) evidence that the uncollectible portion of gross receipts on which tax was paid actually has been legally charged off as a bad debt for income tax purposes or, if the retailer is not required to file income tax returns, charged off in accordance with generally accepted accounting principles;⁸ and 8) the taxable percentage of the amount charged off as a bad debt properly allocable to the amount on which the retailer reported and paid tax. (Cal. Code Regs., tit. 18, § 1642(e).)

On appeal, appellant contends that the measure of the unclaimed bad debt deduction should be increased by \$121,000. Appellant asserts that this amount is comprised of reconditioning costs of \$1,000 per vehicle for 121 vehicles, and that consequently, the wholesale value of these vehicles should be reduced accordingly.⁹ Appellant relies on statements recorded by the auditor in CDTFA Form 836 *Report of Discussion of Audit Findings* (Form 836) that it was impossible for the auditor to determine the repair costs for the repossessed vehicles.

However, this is not evidence that appellant is entitled to an unclaimed bad debt deduction for reconditioning costs on 121 vehicles. Instead, Form 836 is evidence that CDTFA was unable to verify appellant's reconditioning costs. Specifically, Form 836 states that it is not possible to verify whether repair costs are attributable to repossessed vehicles or to vehicles that appellant purchased and repaired for resale. To date, appellant has not provided any evidence

⁸ As found above, appellant did not charge off any bad debt for income tax purposes during the 2011 and 2012 tax years. However, because we find that no adjustment to the measure of bad debt deduction is warranted based on other grounds, we do not analyze whether appellant met the requirements of California Code of Regulations, title 18, section 1642(e).

⁹ The 121 vehicles in question are made up of the 116 vehicles for which CDTFA allowed an unclaimed bad debt deduction and the five vehicles for which no unclaimed bad debt deduction was allowed because CDTFA found that the wholesale value of the five vehicles was greater than the remaining balance of the sales contract.

that he incurred reconditioning costs of \$121,000 for 121 repossessed vehicles. Appellant also has not shown that these alleged reconditioning costs should be included in the measure of the unclaimed bad debt deduction.


Finally, we consider the 16 allegedly repossessed vehicles for which no unclaimed bad debt deduction was allowed. As previously discussed, appellant did not provide any repossession documents for these 16 allegedly repossessed vehicles to CDTFA during the audit. We reject appellant’s assertion that CDTFA should calculate an average unclaimed bad debt deduction and apply it to each of the 16 allegedly repossessed vehicles. Appellant bears the burden of showing entitlement to any claimed deduction or exemption. (*Paine, supra*, 137 Cal.App.3d 438, 443.) As appellant has not provided any evidence that he is entitled to additional unclaimed bad debt deductions, appellant has not met his burden of proof.

HOLDING


Appellant has not shown that adjustments are warranted to the audited amount of unclaimed bad debts.

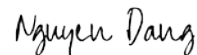
DISPOSITION

Sustain CDTFA’s decision to delete the negligence penalty and to otherwise deny the petition.

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Keith T. Long
Administrative Law Judge

We concur:

DocuSigned by:

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Andrew Wong
Administrative Law Judge

DocuSigned by:

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Nguyen Dang
Administrative Law Judge

Date Issued: 10/28/2020