

# Defending Against **KILLER** Sales Tax Audits

If you're like most dealers, you keep a journal of all your sales. You file your sales invoices, DMV reports, and related sales documents in customer deal folders. With these records, you think a sales tax audit by the State Board of Equalization (Board) would be inconvenient, but nothing to really worry about.

**Think again.** The Board has been hammering used vehicle dealers with assessments ranging from hundreds of thousands to millions of dollars. Many of these assessments far exceed the dealers' true liabilities. They're imposed not because they're right, but because the dealers can't prove they're wrong.

Audits this big usually result from either one of two audit methods. The dealers aren't prepared for these methods, because the audits "go around" most of the usual sales records. Here's how they work and how you can prevent them from burying your business.

## Method 1 – DMV Reports

Board auditors can, and often do, obtain information from the DMV about the reports of sale (ROS) issued to each dealer. An auditor can determine how many reports were issued to a dealer within a given audit period (generally three years) as well as the assigned report numbers. Usually the retail ROS are the ones of interest, since wholesale reports generally involve nontaxable sales for resale.

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The audit approach is simple enough. Rather than relying on the dealer's sales journals and deal folders, the auditor starts with the total number of retail ROS issued during the audit period. Then the auditor subtracts the following:

- The number of recorded retail sales made during the audit period;
- The number of voided reports on hand;
- Any unused reports from the audit period that the dealer has retained.

If the remaining number of reports isn't close to zero, the auditor assumes the missing reports represent unrecorded taxable sales. The number of missing reports is multiplied by your average vehicle sale price, and sales tax is assessed on the result.

This method also can be applied by using test periods within the audit period. If the test indicates a tax understatement, a percentage of error is computed and projected to the rest of the audit period.

In a recent audit of a dealership with three locations, a report of sale count resulted in assumed additional sales of more than \$12 million, creating a sales tax liability of well over \$1,250,000 including interest and penalties. According to the dealer, some of the missing ROS had been returned to the DMV; some had been lost; and some had been destroyed when the related sales didn't go through. Unfortunately, the DMV was unable or unwilling to provide information about reports that the dealer had returned, and the auditor was unwilling to allow for lost or destroyed forms.

The lesson here is obvious: keep complete records of your reports of sale. Save unused, voided, or damaged documents, and if you return forms to the DMV, record the numbers and obtain a date-stamped, signed receipt. An auditor's ROS count can't hurt you if all of your forms are accounted for.



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## Method 2 – Bank Deposits

Like the ROS approach, a bank deposits audit goes behind the normal books and records to create an estimated sales figure. If the estimate exceeds the sales reported to the BOE, the auditor assesses sales tax on the difference.

Once again, the approach is simple. First, the auditor obtains the business bank statements and adds up all of the deposits. Then, the dealer is asked for evidence supporting any deposits that resulted from non-sales activities, such as loan proceeds, transfers from other bank accounts, or insurance recoveries. These receipts are deducted from the total deposits, and the remaining deposits are treated as sales activities.

The deposits are further reduced by proceeds from any nontaxable sales transactions that the dealer can support, such as sales to auctioneers, out-of-state sales, DMV fee collections, and sales tax collected. Whatever's left is presumed to be taxable sales, and if it exceeds the taxable sales that were reported, sales tax is assessed on the difference.

The biggest problem with this kind of estimate is that it proceeds from bank statements that may go back three or more years. Unless clear records of all deposits have been kept, it is virtually impossible to identify every bank transfer, loan deposit (especially from personal loans), advance, refund, repayment, or other non-sale source of funds included in the account. Without documentation, any or all of these types of deposits may be presumed to be taxable sales. Your word alone will not be enough to overcome the presumption.

Where multiple locations and/or bank accounts are involved, or where the dealer is involved in an additional business, a bank deposits audit can create a particularly large false liability. Advances, repayments, and transfers of funds are common in these circumstances, but without a record, such deposits may be treated as additional sales when the audit comes up a couple of years later. The dealer is put in the miserable position of

proving the deposits did not arise from sales, at a time when no one can remember the sources.

The solution is to make note of the source of every deposit, particularly those not originating from sales. The process can be as simple as writing "transfer" or "advance from owner" on your copy of the deposit slip and in your cash receipts journal. Creating the habit now of taking a few seconds to write down a simple description could save you thousands, hundreds of thousands, or more, when the auditor later knocks on your door.

## Nontaxable Sales – Holding Your Exemptions

Let's say you can track every report of sale and identify every bank deposit. You have a complete set of books, and all of your deal folders are intact. When an auditor shows up, you're home free, right?

Not necessarily. Even though the auditor now may accept your total sales as correct, your nontaxable sales will have to be documented. To illustrate, let's look at the two most common types of exempt sales made by auto dealers: sales for resale and sales to out-of-state customers.

**Sales for resale:** Recording a sale as wholesale does not guarantee that the Board will accept it as nontaxable. For the sale to be exempt, the buyer must (1) actually be buying the car to resell it, and (2) give you a completed, signed resale certificate. The certificate then will be good for future sales to the same party until revoked, unless the form specifies that it's only intended for the particular sale involved. (Note: a copy of the buyer's sales tax permit is not a resale certificate and generally will not be accepted as such by an auditor.)

Resale certificates must be taken in good faith. For example, most auditors will accept a completed certificate for a vehicle sold to an auto auctioneer but will question a certificate for a car sold to The Acme Furniture Store.

**Out-of-state sales:** Simply selling a car to a non-California resident does not make the sale nontaxable, even if the customer drives the car out on a one-trip DMV permit. For the exemption to apply, the dealer must deliver the car to the customer outside the state, either by having an employee drive the car there or by hiring a carrier to take it. The dealer then must retain proof of the out-of-state delivery, such as a bill of lading or driver expense receipts. If the customer has a California address or is otherwise known to the dealer as a California resident, the dealer also must obtain a signed statement (preferably notarized at the point of delivery) that the vehicle is being bought for use outside the state.

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## Conclusion

Keeping the right records doesn't just help you track the progress of your business; it also can protect you from being billed for more tax than you owe. A little extra care now just might prevent a disaster later on. 🚗

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