

CALIFORNIA STATE BOARD OF EQUALIZATION
APPEALS DIVISION SUMMARY FOR BOARD HEARING

In the Matter of the Petition for Redetermination)		
Under the Sales and Use Tax Law of:)		
MACROMEDIA, INC.)		Account Number: SR BH 99-152721
Petitioner)		Case ID 461946
		San Jose, Santa Clara County

Type of Business: Website design software

Audit period: 7/01/03 – 12/31/05

<u>Item</u>	<u>Disputed Amount</u>
Disallowed claimed nontaxable and netted sales	\$ 740,805
Difference b/w recorded and reported taxable sales	\$ 649,488
Purchases subject to use tax	\$1,404,426
Tax as determined and proposed to be redetermined:	\$244,717.54
Less concurred	<u>19,256.40</u>
Balance, protested	<u>\$225,461.14</u>
Proposed tax redetermination	\$244,717.54
Interest through 9/30/08 (tax paid in full on 9/24/08)	<u>84,641.26</u>
Total tax and interest	\$329,358.80
Payments	<u>244,717.54</u>
Balance Due	<u>\$ 84,641.26</u>

This matter was previously scheduled for Board hearing on December 16, 2009, but was postponed so that petitioner had time to gather additional supporting documentation.

UNRESOLVED ISSUES

Issue 1: Whether adjustments are warranted to the disallowed claimed nontaxable and netted sales. We recommend no adjustment.

Petitioner sold software for website design until its merger with Adobe Systems, Inc. on December 31, 2005. Petitioner delivered software to its customers both electronically and on compact discs. The only records petitioner provided to the Sales and Use Tax Department (Department) for audit were copies of the sales and use tax returns, a computer file of petitioner's sales with "ship to" addresses in California during the period May 2004 through December 2005 ("recorded sales"), and

resale certificates. Petitioner did not provide purchase records, sales invoices, credit memos, customer's purchase orders, or any other records.

To establish the audited understatement of reported total sales, the Department compared recorded and reported total sales for complete quarters only. Petitioner's recorded total sales for the period July 1, 2004, through December 2005, were \$80,864,847. For the same period, petitioner reported total sales of \$72,368,876, an understatement of \$8,495,971, or 11.74 percent. The Department did *not* separately assess tax on this understatement; rather, this amount was used in the calculated of incorrectly claimed or netted nontaxable sales.

To establish the amounts of error in claimed nontaxable and netted sales, the Department began by segregating the recorded sales for the entire period for which petitioner provided a computer file, May 1, 2004, through December 31, 2005, into three populations: 1) sales invoices with a line item for freight; 2) sales invoices without a line item for freight and with a tax code of exempt; and 3) sales invoices without a line item for freight and without a tax code of exempt. It then separated each population into three strata. For each population, the Department reviewed stratum 3 (the largest sales) on an actual basis and chose random samples of transactions for review from strata 1 and 2. For population 1, the Department computed percentages of error of 1.02 percent for stratum 1 and 1.57 percent for stratum 2, and found errors totaling \$603,775 in its review of stratum 3 on an actual basis (\$6,081 for errors in May and June 2004 and \$597,694 for errors during the period July 1, 2004, through December 31, 2005). The Department found no errors in population 2. The Department found nine errors in population 3 (one in stratum 2 and eight in stratum 3), which totaled \$15,802 (\$3,038 for an error in June 2004 and \$12,764 for errors during the period July 1, 2004, through December 31, 2005).

The Department then computed the overstatement of claimed nontaxable and netted sales for the test period (July 1, 2004, through December 31, 2005). It established the total amounts of strata 1 and 2 of population 1, and applied the percentages of error of 1.02 percent and 1.57 percent, respectively. It then added the errors it found on an actual basis of \$597,694 for stratum 3 of population 1 and \$12,764 for strata 2 and 3 of population 3. The Department computed a total disallowed claimed nontaxable and netted sales for the test period of \$728,470.

The Department then calculated a percentage of error of 0.762 by comparing the \$728,470 measure of errors to the \$95,575,785 of sales recorded for the period May 1, 2004, through December 31, 2005. We note that, since the measure of error was derived from the period July 1, 2004, through December 31, 2005, and was compared to total receipts from that same period *plus* the total receipts from the two prior months, the Department's method of calculation understates the percentage of error (to petitioner's benefit).

For the earlier part of the audit period, July 1, 2003, through June 30, 2004, petitioner reported total sales of \$29,474,880. To calculate audited total sales, the Department regarded petitioner as having underreported total sales during this period in the same percentage as for the later period for which petitioner provided records, that is, 11.74 percent. Applying that percentage understatement to reported sales, the Department calculated audited total sales of \$32,935,176. The Department then applied the 0.762 percentage of error for disallowed claimed nontaxable and netted sales calculated for the later period to compute disallowed claimed nontaxable and netted sales of \$251,029, for a total of \$979,499 for the entire audit period.

Of the sales claimed or netted as nontaxable during the test period which the Department regarded as subject to tax, petitioner disputes only the disallowed claimed and netted nontaxable sales of \$395,141 to California State University, office of the Chancellor (CSU). Petitioner asserts the sales to CSU were sales of software delivered electronically. Petitioner had sent out "XYZ letters"¹ to customers for transactions questioned by the Department. Petitioner relies on CSU's response to the XYZ letter sent to it as well as on an undated letter from a CSU employee stating that CSU did not receive any tangible media.

The agreement between CSU and petitioner does indicate that there would be an electronic delivery of the software, but it also provides that a master copy of the software on storage media would be shipped to CSU. Such shipment of tangible personal property appears to be confirmed by the file

¹ An XYZ letter is a letter sent to a purchaser to whom the seller claims it made a sale for resale, seeking that the purchaser explain the disposition of the purchased property or payment of tax. (Cal. Code Regs., tit. 18, § 1668, subd. (f).) Here, the term is used refer to a letter sent to persons in claimed nontaxable transactions that were questioned by the Department, regardless of basis of the claimed nontaxability.

download provided by petitioner, which contains a line item for a compact disc and a corresponding freight charge or warehouse shipment location (or both) for the transactions at issue. It appears possible that the compact disc was transferred for backup purposes, and that the customer regarded the transaction as primarily an electronic transfer of the software. Nevertheless, we conclude that the record shows the transaction also included the transfer of the software in tangible form. Whether that transfer of tangible media was for backup purposes or for the primary distribution of the software is irrelevant: petitioner transferred the software on tangible media (in addition to any electronic transfer) and thus made a taxable sale of tangible personal property.

Petitioner's other dispute regarding the Department's calculation of disallowed claimed and netted resales is that the Department applied the percentage of error of 0.762 for disallowed claimed nontaxable and netted sales to recorded sales (and for the earlier portion of the audit period, reported sales increased by the error factor of 11.74 percent developed from the later portion of the audit period), rather than applying that percentage of error to reported sales.

Petitioner explains the discrepancy between recorded and reported sales as the result of transactions recorded as sales but never consummated, including holds, voids, and quotes that never materialized into actual sales. Petitioner asserts that its switchover to different software after the merger impaired its ability to properly filter the transactions included in the computer file given to the Department. However, petitioner has not provided credit memos, voided invoices, quote sheets, or any other specific evidence to show that any of the recorded sales in the computer file do not represent consummated sales. Instead, petitioner relies on the fact that some persons responded to the "XYZ" letters it sent by indicating that the questioned transactions had never taken place. Specifically, petitioner states that of the 36 responses to the XYZ letters, representing recorded sales of \$1,687,857, seven indicate that the sales had never occurred, representing recorded sales of \$145,380.² Based on these figures, petitioner calculates two possible percentages for unconsummated transactions included in its recorded sales: 8.61 percent ($\$145,380 \div \$1,687,857$) and 19.44 percent ($7 \div 36$). That is,

² We count 46 responses, six of which indicate that the invoices did not represent consummated sales. We have not attempted to reconcile these differences.

petitioner asserts that responses to letters sent to a portion of its customers, that is, only to persons shown in its records as having made nontaxable purchases where the Department questioned the nontaxability, should be regarded as representative on this issue for *all* of the transactions it recorded in its records, including those recorded as taxable. We do not accept these responses as representative for the purpose asserted by petitioner. We note, in this regard, that every response that indicated the transaction did not occur was accepted as having been properly regarded as not taxable. In the absence of credit memos, voided invoices, quote sheets, or any other specific evidence *at all*, we do not find the responses on which petitioner relies to show that *any* of the transactions recorded as sales in the computer file do not represent consummated sales.

Petitioner also contends it is improbable it would have such a large amount of disallowed claimed and netted nontaxable sales because petitioner is a publicly traded company, regulated by both the SEC and the Sarbanes-Oxley Act, and is audited quarterly by a public accounting company. We find that the fact petitioner is regulated and audited quarterly is wholly irrelevant to the issue of whether it correctly reported its California sales for sales and use tax. The quarterly audit petitioner relies on is not an audit for purposes of determining if petitioner properly reported sales and use tax. Even if the audit included a determination of petitioner's total sales, and even if that amount were correct, petitioner could have made errors in reporting California sales and use tax which would not have been examined during an audit for other purposes.(e.g., an error in allocating the sales among the various states, or segregating the taxable and nontaxable sales). In that regard, we note that the information the Department relied on was net of sales that petitioner's records showed as shipped to customers in other states. Such sales delivered from California were required to be reported on line 1 of petitioner's returns, and, if qualifying for exemption, deducted as appropriate. Had petitioner reported correctly, the Department presumably would have tested the claimed exempt interstate sales to ensure that they were claimed properly. However, the Department effectively accepted all such sales as exempt sales without any review since it included no deficiency for sales which were neither reported nor recorded (i.e., netted from both returns and records, such as all sales which reflected out-of-state delivery addresses).

Issue 2: Whether adjustments are warranted to the audited amount of recorded, but not reported, taxable sales. We recommend no adjustment.

The computer file petitioner provided the Department reflected accrued sales tax of \$709,936 for the period July 1, 2004, through December 31, 2005. For the same period, petitioner reported sales tax of \$671,653, which is \$38,283 less than it recorded, for an error rate of 5.7 percent. The Department applied that percentage of error to the amount of sales tax reported for the remainder of the audit period to calculate the additional understatement of reported tax for that period of \$18,000, for a total understatement of recorded sales tax of \$56,283. Based on this amount, the Department calculated the associated taxable measure that had not been recorded, but not reported, of \$649,488.

As discussed under Issue 1, petitioner contends the amount of sales recorded in the computer file includes transactions that were never consummated. We find petitioner's arguments on this point even less convincing in the context of transactions for which petitioner's records shows tax reimbursement was collected. Petitioner has not provided sales invoices, credit memos, quote sheets, or any similar records to substantiate its contention that some of the recorded tax reimbursement was never actually charged and collected. Nor has petitioner provided any other records from which the Department could establish such amounts collected by petitioner except for the records provided in the computer file that show petitioner collected tax reimbursement of \$709,936 for the period July 2004 through December 2005, during which period petitioner reported sales tax of \$671,653. The burden is on petitioner to establish the taxable sales listed in its own records were not actual sales. We find that petitioner has not met that burden, and that no adjustment is warranted.

Issue 3: Whether adjustments are warranted to the understated amount of ex-tax purchases subject to use tax. We recommend no adjustment.

Petitioner did not provide purchase records for use by the Department in verifying the accuracy of petitioner's recorded purchases subject to use tax, so the Department used information from its audit of the period January 1, 2000, through December 31, 2002, to calculate the taxable percentage of petitioner's purchases. During that prior audit period, petitioner reported purchases subject to use tax equal to 6.558 percent of its reported total sales, while in the current audit period it reported purchases subject to use tax equal to 1.188 percent of its reported total sales. The Department concluded that

petitioner's reported purchases subject to use tax were understated. Petitioner's reported measure of use tax during the last year of the prior audit equaled 2.567 percent of its total reported sales for that year. The Department compared this percentage to the 1.188 percent that petitioner's reported measure of use tax bore to its total reported sales to calculate an understatement equal to 1.379 percent of reported total sales.

Petitioner contends that there was no understatement of reported purchases subject to use tax. Petitioner notes that the Department did not find errors in reported purchases subject to use tax in three prior audits. Petitioner contends that its sales were independent of its purchases, and the use of a percentage of purchases subject to use tax to total sales is not practical. Further, petitioner contends that the audited amount of purchases subject to use tax does not account for the fact that, during the audit period at issue, petitioner was preparing to close or sell its business, which resulted in a decrease of purchases.

Petitioner's arguments are logical and seem to support its contention that there was no understatement of use tax. Indeed, the trend of the prior audit (6.558 percent overall, but 2.567 percent in the final year) is relatively consistent with petitioner's use tax reported for the present audit period. That is, petitioner reported purchases subject to use tax equal to 10.66 percent of its reported total sales for 2000, 5.42 percent for 2001, 2.57 percent for 2002, and 1.188 percent in the audit period at issue. However, petitioner has provided no purchase records whatsoever that the Department could use to evaluate the accuracy of reported amounts. Since the D&R does not clearly set forth the difficulty of evaluating this matter, we will provide additional explanation here.

Petitioner was previously audited three times, for the period January 1, 1992, through March 31, 1995, for the period October 1, 1995, through September 30, 1998, and for the period January 1, 2000, through December 31, 2002. In the first audit, the Department did not examine petitioner's purchase invoices, but the audit workpapers noted that the auditor had worked with petitioner to develop a method for identifying and recording use tax liability in the future. In the next audit, the Department conducted a spot test and discovered no errors in reported purchases subject to use tax. In the most recent prior audit, the Department reviewed petitioner's purchase invoices for the

test period April 1, 2001, through March 31, 2002, and found that purchases subject to use tax had been properly reported.

The audit period at issue here (July 1, 2003, through December 31, 2005) begins about one year after that test period. Thus, the test in the prior audit is sufficiently close in time to the current audit period to be regarded as an indication that petitioner's reported purchases subject to use tax in the current audit period were also reliable. This is particularly true since the Department found no unreported purchases subject to use tax in the three audits which spanned the 11-year period January 1, 1992 through December 31, 2002.

The Department has also acknowledged petitioner's argument that purchases of equipment and supplies are not necessarily dependent on sales in stating that the use of a percentage of purchases subject to use tax to total sales is not the most reliable method for establishing audited purchases subject to use tax. However, regarding petitioner's argument that it was preparing to close its business, the Department responds that the audit *does* account for that change in business operations by using the 2.567 percent figure calculated for the last year of the prior audit rather than the 6.558 calculated for the entire three years of the prior audit period.

Despite the logic of petitioner's arguments, we also find that the Department's method for calculating the use tax deficiency is logical and supportable. Petitioner was required to maintain records and present them for audit, but it did not do so, presenting no records *at all* of purchases for this audit period. Petitioner's arguments do not establish that it made no mistakes in reporting use tax. We conclude, based on the complete lack of purchase records, that petitioner has failed to provide evidence that the Department's conclusion is incorrect or from which a more accurate determination may be made, and we recommend no adjustment.

OTHER DEVELOPMENTS

None.

Summary prepared by Deborah A. Cumins, Business Taxes Specialist III

Statistical Sample

Transactions Examined	Nontaxable Sales
Confidence level	80%
Confidence interval	8.128%*
Total number of items in the population	9,559 for stratum 1 2,312 for stratum 2 268 for stratum 3
Number of items randomly selected for the test	500 for stratum 1 300 for stratum 2 268 for stratum 3
Number of errors found	8 for stratum 1 8 for stratum 2 26 for stratum 3)
Whether stratification was used, and if so what was stratified	Stratified by sales amount \$100 - \$1000 \$1000.01-\$10,000 Greater than \$10,000
Average dollar value of population	\$383 for stratum 1 \$2,532 for stratum 2 \$32,522 for stratum 3
Dollar value of remaining errors	\$1,942 for stratum 1 \$12,316 for stratum 2 \$603,775 for stratum 3
Dollar value of sample	\$191,096 for stratum 1 \$783,721 for stratum 2 \$8,715,818 for stratum 3
Percentage of error	1.02% for stratum 1 1.57% for stratum 2 Actual basis for stratum 3
Were XYZ letters sent	yes
Number of XYZ letters sent	57
Percentage of XYZ letters sent in relation to number of tested items	7%**
Number of responses to XYZ letters received	46**
Percentage of responses to XYZ letters received in relation to the number of XYZ letters sent	81%
Number of responses to XYZ letters received accepted as proof of valid nontaxable sales	38
Percentage of responses to XYZ letters received accepted as proof of valid nontaxable sales	83%
Number of responses to XYZ letters treated as taxable	8
Percentage of responses to XYZ letters treated as taxable	17%

*The Department computed one confidence interval for the stratified random sample, as a whole.

**It is not clear from the audit workpapers whether one XYZ letter was sent when there were more than one invoice to the same customer. Accordingly, the percentage of 7% is an estimate. This may also be the reason that we counted 46 responses to XYZ letters while petitioner states there were 36 responses.