

1 CALIFORNIA STATE BOARD OF EQUALIZATION

2 APPEALS DIVISION BOARD HEARING SUMMARY

3 In the Matter of the Petition for Redetermination)
 4 Under the Sales and Use Tax Law of:)
 5 GLOBAL AIR COM, INC.) Account Number SR X GH 97-891095
 Case ID 488913)
 6 GLOBAL AIR CONNECTION, LLC) Account Number SR X GH 100-693832
 Case ID 488785)
 7 Petitioners
 8 _____ San Jose, Santa Clara County

9 Type of Business: Cell phone dealers

10 Audit period: 04/01/05 – 07/31/06 (Case ID 488913)
 02/01/06 – 03/31/08 (Case ID 488785)

<u>Item</u>	<u>Disputed Amount</u>			
	<u>(Case ID 488913)</u>		<u>(Case ID 488785)</u>	
12 Unreported sales	\$1,569,145		\$1,590,679	
13 Interest	Unstated		Unstated	
	<u>(Case ID 488913)</u>		<u>(Case ID 488785)</u>	
	<u>Tax</u>	<u>Penalty</u>	<u>Tax</u>	<u>Penalty</u>
15 As determined	\$235,204.06	\$23,520.40	\$173,132.82	\$17,313.30
16 Post-D&R adjustment	<u>- 105,749.56</u>	<u>- 23,520.40</u>	<u>- 41,901.75</u>	<u>- 17,313.30</u>
17 Proposed redetermination, protested	<u>\$129,454.50</u>	<u>\$0.00</u>	<u>\$131,231.07</u>	<u>\$0.00</u>
18 Proposed tax redetermination	\$129,454.50		\$131,231.07	
Interest through 11/30/12	<u>71,704.65</u>		<u>57,363.34</u>	
19 Total tax and interest	\$201,159.15		\$188,594.41	
Payments	<u>- 3,300.00</u>		<u>- 572.37</u>	
20 Balance Due	<u>\$197,859.15</u>		<u>\$188,022.04</u>	
21 Monthly interest beginning 12/01/12	<u>\$ 630.77</u>		<u>\$ 653.29</u>	

22 This matter was scheduled for Board hearing in August 2012, but was postponed at petitioners'
 23 request to allow additional time to prepare for the hearing.

24 **UNRESOLVED ISSUES**

25 **Issue 1:** Whether adjustments are warranted to unreported sales. We find no further
 26 adjustments are warranted.

27 Petitioners, Global Air Com, Inc. (the corporation) and Global Air Connection LLC (the LLC),
 28 sold cell phones in bundled transactions and sold cell phone accessories for the periods July 2001

1 through July 2006 and February 2006 through December 2009, respectively. Petitioners are related
2 through family members and accounting personnel. For audit, petitioners provided various records,
3 including a summary list of cell phone equipment purchases, sorted between purchases for the
4 corporation and the LLC. Petitioners also provided a list of accessory purchases.

5 The Sales and Use Tax Department (Department) found that reported sales represented the net
6 amounts that petitioners had actually charged their customers for phones in bundled transactions, with
7 no amount reported if no charge was made for the cell phone. Since petitioners' records did not reflect
8 any unbundled selling prices for cell phones, the Department established audited sales of cell phones
9 on a markup basis, using an estimated markup of 18 percent based on California Code of Regulations,
10 title 18, section (Regulation) 1585. The Department did not include any accessory costs in the
11 equipment costs subject to markup since petitioners stated that accessories were not sold separately but
12 were included in bundled transactions as incentives, for no additional charge. The Department
13 established understatements of reported taxable sales of \$2,850,958 for the corporation and \$2,098,579
14 for the LLC.

15 Petitioners dispute the estimated markup of 18 percent, arguing that they sold cell phones at
16 cost or less since their income was mainly from commissions received from the service providers.¹ At
17 the appeals conference, however, petitioners' primary argument was that adjustments are warranted to
18 the audited cost of cell phone equipment sold. Petitioners argued that several specific adjustments
19 were necessary to the audited cost of cell phone equipment sold in taxable transactions. The D&R
20 recommends a reaudit and specifies certain documentation to be provided by petitioners to support
21 adjustments. In the post-D&R reaudit, the Department reduced the total cost of cell phone purchases
22 by \$501,476 based on a re-examination of the records to address a clerical error identified in the D&R.
23 Then, to establish the audited cost of taxable sales of cell phones, the Department reduced the audited
24 cost of cell phones by: 1) \$27,049 for erroneous postings to the equipment purchases account, such as
25 accessory purchases recorded as cell phone purchases; 2) \$67,937 for a one percent pilferage

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27 ¹ Commissions received from service providers under these facts are taxable gross receipts received by the retailer from the
28 retail sale of the cell phones. However, Regulation 1585 sets forth an alternative method of reporting tax, which was
adopted to provide a much easier method to report tax than having to report tax on the actual commissions.

1 allowance for lost phones; 3) \$23,992 for damaged phones; 4) \$506,750 for the cost of cell phones sold
2 for resale or sold in interstate commerce; and 5) \$389,508 for the taxable cell-phone portion of charge-
3 backs, for a total reduction in the costs of cell phone equipment sold (for both businesses combined) of
4 \$1,516,712, from \$7,295,158 to \$5,778,446 (\$3,009,539 purchased by the corporation and \$2,768,907
5 purchased by the LLC). The Department then added an estimated markup of 18 percent to establish
6 audited taxable sales, which it compared to reported figures to establish the amounts of understatement
7 in dispute. In a letter dated November 8, 2011, we expressed our understanding that petitioner was in
8 agreement with the reaudit findings. However, in a December 6, 2011 letter, petitioners requested a
9 Board hearing stating that they dispute: 1) the basis for the calculation of the deficiency; 2) the amount
10 of the deficiency; and 3) the penalty assessment.

11 In the post-D&R reaudit, the Department addressed each of petitioners' requested adjustments
12 to the audited cost of cell phone equipment purchases and made the adjustments for which petitioners
13 provided documentation. Petitioners have not provided any additional evidence, and we find no
14 further adjustments are warranted to the cost of cell phone equipment sold in taxable transactions.
15 Further, the Department's use of an 18 percent markup was consistent with Regulation 1585.
16 Accordingly, we recommend no further adjustment to the amount of unreported sales.

17 **Issue 2:** Whether relief of interest is warranted. We find that relief is not warranted.

18 Petitioners request relief of interest from May 2009 until the day that they pay the tax amount
19 due. Petitioners allege that they had submitted additional documentation to the Department in March
20 2009 but that the Notices of Determination were issued in April 2009 without further discussion.
21 Petitioners also state that they appeared at the district office for three scheduled meetings with the
22 District Principal Auditor only to be informed that the meetings had been canceled without prior
23 notice.

24 Based on our review of the record, we find there were no unreasonable delays by the
25 Department in the processing of this matter. Further, it was petitioners' responsibility to provide
26 source documents to establish that adjustments were warranted, but they did not provide that evidence
27 until the post-D&R reaudit was conducted. Thus, we find that a significant aspect of any delay is
28 attributable to petitioners' failure to provide adequate supporting documentation. Under those

1 circumstances, no relief of interest is warranted. (Rev. & Tax. Code, § 6593.5, subd. (b).) Regarding
2 petitioners' assertion that scheduled meetings with the District Principal Auditor were canceled
3 without notice, the Department indicates that, for the first two meetings petitioners arrived late, and the
4 District Principal Auditor could not meet with them at the later times because of prior commitments,
5 and, for the third meeting, the District Principal Auditor was called away unexpectedly. The fact
6 remains that petitioners did not provide the source documents, even as late in the process as the appeals
7 conference, although those documents must have been in petitioners' possession all along. Thus, we
8 find that petitioners, rather than the Department, were the primary source of any delays.

9 **RESOLVED ISSUE**

10 The Department assessed negligence penalties because petitioners failed to inform themselves
11 regarding the correct application of tax to sales of cell phones in bundled transactions and therefore
12 failed to properly report their sales tax liabilities, and because the amounts of understatement were
13 substantial. In our D&R, we recommended that the penalties be sustained. However, in preparing this
14 appeal for Board hearing, we have reconsidered that recommendation. The deficiency is almost
15 entirely a function of petitioners' failure to report tax in accordance with Regulation 1585. If
16 petitioners' failure to report in accordance with Regulation 1585 was negligent, then the size of the
17 deficiency is not terribly relevant (though supportive of the negligence penalty). However, if
18 petitioners' failure to report in accordance with Regulation 1585 was not negligent, then the size of the
19 deficiency resulting from that failure cannot transmute the non-negligent failure into negligence. Thus,
20 we examine whether petitioners' failure to conform to the requirements of Regulation 1585 was
21 negligent.

22 A taxpayer certainly has a duty to inform itself of the proper method of reporting tax for its
23 business. However, we have not regarded the failure to do so as absolute proof of negligence. Rather,
24 the Board leans towards leniency on this issue in a first audit situation, as here. If this were a situation
25 where petitioners' business were a more "regular" business with respect to the application of sales tax,
26 we would look at the situation differently. However, petitioners sold cell phones in bundled
27 transactions, which, despite the Board's adoption of Regulation 1585 several years before the
28 beginning of the liability periods at issue here, continues to vex cell phone retailers and their

1 customers. That the regulation has a very clear and valid basis, and in fact makes reporting tax easier
2 than the alternative and, in most cases, results in a lower tax being due than the alternative, does not
3 overcome the basic fact that the concept is difficult for non-sales tax experts to grasp (and even for
4 some sales tax experts).

5 If petitioners had correctly identified their business when obtaining their seller's permits, we
6 would have expected the Department to have provided a copy of Regulation 1585. Had the
7 Department shown that it did so, we would find that alone is sufficient to warrant application of the
8 negligence penalties. However, our understanding is that the Department did not provide petitioners a
9 copy of Regulation 1585 when they obtained their seller's permits, or provide them any other specific
10 information which would have helped petitioners to report tax properly. In sum, considering that
11 petitioners had not been audited previously, the nature of how sales tax applies to bundled sales of cell
12 phones, and the Department's apparent failure to provide helpful publications to petitioners when they
13 obtained their seller's permit, we believe it is appropriate to give petitioners the benefit of doubt on the
14 issue of negligence. We therefore now recommend that the negligence penalties be removed.

15 **OTHER MATTERS**

16 None.

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18 Summary prepared by David H. Levine, Tax Counsel IV
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MARKUP TABLE

Percentage of taxable vs. nontaxable purchases	100%
Mark-up percentage (estimated)	18%
Self-consumption allowed in dollars	None
Pilferage allowed in dollars	\$67,937 (4/1/05 – 3/31/08)
Pilferage allowed as a percent of taxable purchases	1%