STATE BOARD OF EQUALIZATION
SALES AND USE TAX APPEAL

CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION BOARD HEARING SUMMARY

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

Type of Business: Cell phone dealers

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

Item	Disputed Amount (Case ID 488913)	Disputed Amount (Case ID 488785)
Unreported sales	$1,569,145	$1,590,679
Interest	Unstated	Unstated

	(Case ID 488913) Tax	(Case ID 488913) Penalty	(Case ID 488785) Tax	(Case ID 488785) Penalty
As determined	$235,204.06	$23,520.40	$173,132.82	$17,313.30
Post-D&R adjustment	- 105,749.56	- 23,520.40	- 41,901.75	- 17,313.30
Proposed redetermination, protested	$129,454.50	$0.00	$131,231.07	$0.00
Proposed tax redetermination	$129,454.50		$131,231.07	
Interest through 08/31/12	69,812.34		55,403.47	
Total tax and interest	$199,266.84		$186,634.54	
Payments	- 3,300.00		- 572.37	
Balance Due	$195,966.84		$186,062.17	
Monthly interest beginning 09/01/12	$ 630.77		$ 653.29	

UNRESOLVED ISSUES

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

Petitioners, Global Air Com, Inc. (the corporation) and Global Air Connection LLC (the LLC), sold cell phones in bundled transactions and sold cell phone accessories for the periods July 2001 through July 2006 and February 2006 through December 2009, respectively. Petitioners are related through family members and accounting personnel. For audit, petitioners provided various records,

including a summary list of cell phone equipment purchases, sorted between purchases for the corporation and the LLC. Petitioners also provided a list of accessory purchases.

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

Petitioners dispute the estimated markup of 18 percent, arguing that they sold cell phones at cost or less since their income was mainly from commissions received from the service providers.[1] At the appeals conference, however, petitioners' primary argument was that adjustments are warranted to the audited cost of cell phone equipment sold. Petitioners argued that several specific adjustments were necessary to the audited cost of cell phone equipment sold in taxable transactions. The D&R recommends a reaudit and specifies certain documentation to be provided by petitioners to support adjustments. In the post-D&R reaudit, the Department reduced the total cost of cell phone purchases by $501,476 based on a re-examination of the records to address a clerical error identified in the D&R. Then, to establish the audited cost of taxable sales of cell phones, the Department reduced the audited cost of cell phones by: 1) $27,049 for erroneous postings to the equipment purchases account, such as accessory purchases recorded as cell phone purchases; 2) $67,937 for a one percent pilferage allowance for lost phones; 3) $23,992 for damaged phones; 4) $506,750 for the cost of cell phones sold for resale or sold in interstate commerce; and 5) $389,508 for the taxable cell-phone portion of charge-

[1] Commissions received from service providers under these facts are taxable gross receipts received by the retailer from the 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 reported tax on the actual commissions.

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

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

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

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

Based on our review of the record, we find there were no unreasonable delays by the Department in the processing of this matter. Further, it was petitioners' responsibility to provide source documents to establish that adjustments were warranted, but they did not provide that evidence until the post-D&R reaudit was conducted. Thus, we find that a significant aspect of any delay is attributable to petitioners' failure to provide adequate supporting documentation. Under those circumstances, no relief of interest is warranted. (Rev. & Tax. Code, § 6593.5, subd. (b).) Regarding petitioners' assertion that scheduled meetings with the District Principal Auditor were canceled without notice, the Department indicates that, for the first two meetings petitioners arrived late, and the

District Principal Auditor could not meet with them at the later times because of prior commitments, and, for the third meeting, the District Principal Auditor was called away unexpectedly. At this point, we cannot determine the specifics of those scheduling matters, but the fact remains that petitioners did not provide the source documents, even as late in the process as the appeals conference, although those documents must have been in petitioners' possession all along. Thus, we find that petitioners, rather than the Department, were the primary source of any delays.

RESOLVED ISSUE

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

A taxpayer certainly has a duty to inform itself of the proper method of reporting tax for its business. However, we have not regarded the failure to do so as absolute proof of negligence. Rather, the Board leans towards leniency on this issue in a first audit situation, as here. If this were a situation where petitioners' business were a more "regular" business with respect to the application of sales tax, we would look at the situation differently. However, petitioners sold cell phones in bundled transactions, which, despite the Board's adoption of Regulation 1585 several years before the beginning of the liability periods at issue here, continues to vex cell phone retailers and their customers. That the regulation has a very clear and valid basis, and in fact makes reporting tax easier than the alternative and, in most cases, results in a lower tax being due than the alternative, does not

overcome the basic fact that the concept is difficult for non-sales tax experts to grasp (and even for some sales tax experts).

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

OTHER MATTERS

None.

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%