

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 MOBILE TELESYS, INC.) Account Number SR Y FH 97-205730
 6 Petitioner) Case ID 486216
 7) San Diego, San Diego County

8 Type of Business: Sales of cellular telephones, accessories, and service contracts

9 Audit period: 04/01/02 – 06/30/03

10 <u>Item</u>	<u>Disputed Amount</u>
11 Unreported taxable sales	\$5,628,217
12 Bad debts deduction	unspecified
12 Negligence penalty	\$ 45,025
13 Tax as determined and protested	\$450,257.41
14 Interest through 03/31/13	378,950.16
14 Negligence penalty	45,025.75
15 Amnesty double negligence penalty	32,989.66
15 Amnesty interest penalty	<u>31,961.07</u>
16 Total tax, interest, and penalty	<u>\$939,184.05</u>
17 Monthly interest beginning 04/01/13	<u>\$ 2,251.29</u>

18 This is an appeal that is covered by Revenue and Taxation Code section (Section) 40.

19 Therefore, after the Board has made a determination in this matter, a written opinion that, among other
 20 things, sets forth the relevant factual findings and the legal analysis on which that determination is
 21 based must be published on the Board's website within 120 days from the date the Board renders a
 22 final decision in this matter. Accordingly, the Board may wish to consider the following two options:

23
 24 (A) The Board could follow its usual practice in business tax appeals, in which it typically
 25 votes to resolve the appeal on the day of the hearing. Under the usual practice, a notice of the
 26 Board's determination will be mailed within 45 days of the date of the Board's vote, and the
 27 30-day period for the filing of a Petition for Rehearing (PFR) would begin on the date the
 28 notice is mailed. If a PFR is not filed, the Board's determination will become final and its
 decision will be rendered at the expiration of the 30-day PFR period. Unless the Board
 specifically directs that it desires to issue a precedential (Memorandum Opinion) decision in
 this matter, staff would then expeditiously bring back a proposed (nonprecedential) Summary
 Decision that complies with Section 40 for the Board's approval on a later calendar. The

1 adopted decision will be published timely on the Board's website. If a PFR is filed, no decision
2 will be rendered until the conclusion of the petition for rehearing process.

3 (B) The Board could inform staff of its tentative determination and direct staff to prepare a
4 proposed Summary Decision (or Memorandum Opinion) that reflects the tentative
5 determination for Board approval as soon as practicable. Under this option, the Board would
6 hold any determination of the appeal in abeyance until it has the opportunity to consider the
7 proposed decision. The Board's later vote to adopt the decision would also constitute its vote
8 to resolve the appeal, and within 45 days a notice of decision would be mailed. The 30-day
9 PFR period would begin running when the notice of the Board's determination was mailed. If
10 no PFR is filed, the Summary Decision (or Memorandum Opinion) would then be timely
11 posted on the Board's website pursuant to Section 40.

12 We also note that petitioner could request during the oral hearing that the Board take Option B
13 above and defer its vote to determine the appeal until it adopts a Summary Decision (or Memorandum
14 Opinion). Such a request would, of course, defer resolution of the appeal and interest would continue
15 to accrue. On the other hand, petitioner may prefer that the Board follow its usual practice in business
16 tax appeals, which typically would result in a vote to resolve the appeal on the day of the hearing, thus
17 accelerating the resolution process, but potentially requiring petitioner to file a PFR before it sees the
18 content of the Summary Decision (or Memorandum Opinion) adopted by the Board.

19 In response to a Notice of Appeals Conference, petitioner's representative advised the Board
20 Proceedings Division that he was waiving appearance at the appeals conference, which was held as
21 scheduled.

22 UNRESOLVED ISSUES

23 **Issue 1:** Whether adjustments are warranted to the amount of unreported taxable sales. We
24 find no adjustment is warranted.

25 Petitioner sold cellular telephones, related accessories, and Verizon Wireless (Verizon) service
26 contracts from January 1998 through June 2003. Petitioner consistently reported its total sales as
27 taxable sales. Although petitioner used a computerized point-of-sale accounting system, which should
28 have accurately tracked and recorded sales data, petitioner provided limited records for audit,
consisting of copies of sales and use tax returns, summaries or worksheets from various locations, and
a copy of petitioner's 2003 federal income tax return. These records showed that petitioner collected
sales tax reimbursement, measured by the retail selling price of tangible personal property sold.

1 The Sales and Use Tax Department (Department) found that gross receipts of \$10,901,011
2 reported on petitioner's 2003 federal tax return exceeded total sales reported on petitioner's sales and
3 use tax returns for 2003 of \$1,918,191 by \$8,982,820. In light of that significant discrepancy, the
4 Department decided to establish audited taxable sales on a markup basis, and it used 2003 as a test
5 period since it did not have cost of goods sold information for the remainder of the audit period. The
6 Department noted that petitioner had reported zero for cost of goods sold for 2003, which represented
7 beginning inventory of \$548,452 plus purchases of \$2,767,475 and other costs of \$461,342 less ending
8 inventory of \$3,777,269. Since the federal tax return also reflected gross receipts over \$10 million, the
9 Department found it implausible that there was no reduction of inventory (and thus a zero cost of
10 goods sold) during that year. In the absence of other information, the Department decided to use
11 purchases of \$2,767,475 (shown on the federal tax return) as the audited cost of goods sold, and it
12 estimated that 90 percent of the merchandise sold represented phones, while the remaining 10 percent
13 represented accessories. The Department reduced the costs in both categories by pilferage losses,
14 estimated at 2 percent. It then added an 18 percent markup to compute audited sales of phones and a
15 100 percent markup to compute audited sales of accessories. The Department compared audited sales
16 of phones and accessories to reported taxable sales for 2003 and computed an understatement of
17 78.43 percent, which it applied to reported taxable sales for the audit period.

18 Petitioner contends it was not in the business of selling telephones and accessories, but was in
19 the business of selling Verizon's cellular service contracts. Petitioner states that it gave telephones and
20 accessories away as an incentive for the customer to purchaser a minimum two-year cellular service
21 contract, and that the few telephone sales it made were to customers who wanted more than the basic
22 "free" phone. Petitioner thus asserts that the maximum measure of tax should be its cost, arguing that
23 it provided telephones and accessories to its customers in exchange for less than 50 percent of its cost
24 for the equipment, and it states that the cost of phones and accessories has already been reported on its
25 returns. Petitioner further states that it experienced extensive losses from theft and obsolescence.¹

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27 ¹ Petitioner also claims that the beginning inventory for 2003 consisted of obsolete telephones that should not be counted as
28 marketable inventory, but that argument is not applicable since the beginning inventory has not been used in the audit
computations.

1 Petitioner has provided no evidence to show that it gave telephones away and reported the cost
2 of telephones on its returns. In that regard, the amount of \$1,918,191 reported on petitioner's sales and
3 use tax returns for 2003 was much less than its cost of merchandise of \$2,767,475, which belies its
4 assertion that it was reporting the cost of equipment as the taxable amount. Also, these figures do not
5 support a conclusion that the phones were sold for less than 50 percent of the cost because reported
6 sales for 2003 are less than the recorded costs by only about 31 percent. Thus, we find the evidence
7 does not support petitioner's assertion that the measure of tax should be its cost of the phones and
8 accessories. Petitioner did not provide records from which the Department could compute a markup,
9 and, in any event, there was no evidence that petitioner had made any unbundled sales from which the
10 retail selling prices of telephones could be determined. Accordingly, it was appropriate for the
11 Department to use a markup of 18 percent for sales of phones. (Cal. Code of Regs., § 1585, subd.
12 (a)(4).) Also, we find the estimated markup of 100 percent was reasonable for sales of accessories.
13 Petitioner has offered no persuasive evidence to show that the audited markups are excessive.

14 Regarding petitioner's claim that the difference between gross receipts reported on its federal
15 tax return and total sales reported on the sales and use tax returns for 2003 represents commissions
16 paid by Verizon, petitioner has provided no evidence. In any event, the nature of that difference is not
17 germane to this analysis since the Department did not use that difference to establish audited sales.
18 Petitioner also has not offered evidence to support its assertion that there were extensive losses due to
19 theft and obsolescence. The Department has already allowed losses due to pilferage of 2 percent,
20 which is greater than the standard 1 percent allowance, and petitioner has not provided documentation
21 of additional losses. In summary, we find that petitioner has not identified errors in the audit
22 procedures or computations, and it has not provided records from which a more accurate amount of
23 sales could be established. Accordingly, we find no adjustment is warranted.

24 **Issue 2:** Whether an adjustment is warranted for bad debts. We find no adjustment is
25 warranted.

26 Although petitioner has not specifically claimed that it is entitled to an adjustment for bad
27 debts, there is information in the file that suggests that this is a potential argument. However, since
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1 petitioner has provided no specific argument and no evidence of bad debts, we find no adjustment is
2 warranted.

3 **Issue 3:** Whether petitioner was negligent. We conclude that it was.

4 The Department imposed the negligence penalty because it found that petitioner's records were
5 not adequate for sales and use tax purposes. Petitioner argues simply that it was not negligent.

6 Petitioner had a computerized point-of-sale accounting system in its various locations, but it did
7 not provide any records from that system for audit. As explanation, petitioner has stated only that the
8 records either were not created or were lost because there was such a climate of despair and animosity
9 toward Verizon in the final weeks the business operated. That explanation is not adequate, since the
10 obligation to maintain adequate business records is not dependent on a taxpayer's relationships with its
11 customers or affiliates. Moreover, the explanation does not address why the business records were not
12 available for the years before the final weeks when the relationship between petitioner and Verizon
13 allegedly soured. Further, we note that the understatement over \$5 million is substantial, and the
14 percentage of error is over 78 percent. We find that the unavailability of records that petitioner had
15 apparently maintained and the amount of understatement are evidence of negligence, and that the
16 penalty was properly applied even though petitioner had not been audited previously.

17 **OTHER MATTERS**

18 Since petitioner did not participate in the amnesty program, an amnesty double negligence
19 penalty of \$32,989.66 has been added to the determination, and an amnesty interest penalty of
20 \$31,961.07 will be added when the liability becomes final. Petitioner's representative has stated that
21 petitioner has gone out of business, and he is unable to contact anyone from whom he can obtain a
22 request for relief of the amnesty penalties. Although we explained to the representative that we would
23 accept a request for relief signed by him under penalty of perjury, he has declined to file such request.
24 Accordingly, we have no basis to consider recommending relief of the amnesty double negligence
25 penalty or the amnesty interest penalty.

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

Estimated percentage of purchases – phones -- accessories	90% 10%
Mark-up percentages developed	18% -phones 100% - accessories
Self-consumption allowed in dollars	None
Pilferage allowed in dollars	\$55,350 for 2003
Pilferage allowed as a percent of taxable purchases	2%