

CALIFORNIA STATE BOARD OF EQUALIZATION
APPEALS DIVISION SUMMARY FOR BOARD HEARING

In the Matter of the Petition for)
Redetermination and Claim for Refund)
Under the Sales and Use Tax Law of:)
PEELLE TECHNOLOGIES, INC.) Account Number: SR GH 97-082507
Petitioner) Case ID's 390328, 451512
Campbell, Santa Clara County

Type of Business: Sales of computer hardware and software

Audit period: 01/01/02 – 09/30/05

<u>Item</u>	<u>Disputed Amount</u>
Disallowed claimed nontaxable sales	\$166,666
Amnesty interest penalty	\$ 4,419
Claimed refund of tax	\$ 13,718
Tax as determined:	\$117,189.43
Adjustment - Sales and Use Tax Department	<u>- 16,662.38</u>
Proposed redetermination	\$100,527.05
Less concurred	<u>- 87,873.52</u>
Balance, protested	<u>\$ 12,653.53</u>
Proposed tax redetermination	\$100,527.05
Interest	42,675.00
Amnesty interest penalty	<u>4,419.45</u>
Total tax, interest, and penalty	\$147,621.50
Payments	<u>- 102,672.68</u>
Balance Due	<u>\$ 44,948.82</u>

UNRESOLVED ISSUE

Issue: Whether the disputed charges for software maintenance contracts were taxable. We find that the charges were taxable, and that the petition and claim for refund should be denied.

Petitioner sells computer software and hardware and provides related services. The Sales and Use Tax Department (Department) examined claimed nontaxable sales on an actual basis. The charges that are in dispute were made by petitioner for software maintenance contracts it sold in connection with sales of software it had acquired from its vendor EMC. In its review of petitioner's maintenance contracts, the Department regarded charges for mandatory maintenance agreements as fully taxable, and with respect to optional maintenance contracts where the purchasers received tangible personal

1 property such as hard copies of the software updates, regarded the charges as fully taxable for contracts
2 prior to January 1, 2003, and 50 percent taxable for contracts thereafter in accordance with the
3 applicable provisions of California Code of Regulations, title 18, section (Regulation) 1502. Since
4 petitioner was unwilling to provide the actual maintenance contracts themselves on the basis that the
5 contracts are confidential, the Department contacted EMC and talked with Mr. Leers Thurfjell, who
6 identified himself as the inside sales/renewal sales representative for EMC. Mr. Thurfjell stated that
7 that the first year of EMC's maintenance contracts were all mandatory, and that EMC offered
8 maintenance contracts on an optional basis thereafter. He also stated that, through 2004, EMC had
9 provided hardcopies of software updates as part of the optional maintenance contracts. Consequently,
10 the Department determined that petitioner's charges for optional maintenance contracts for EMC's
11 products were 100 percent taxable in 2002, 50 percent taxable in 2003 and 2004, and nontaxable in
12 2005.

13 Petitioner asserts that some of the maintenance contracts regarded as mandatory by the
14 Department were in fact optional maintenance contracts, and it disputes that EMC provided hard
15 copies of updates, contending that, at all times relevant to the audit, EMC provided hard copies only if
16 they were specifically requested by the purchaser. As support, petitioner provided a declaration of
17 Mr. Gary Bluhm, the Partner Channel account manager for EMC, stating that, for the period 2002
18 through 2004, software updates were generally provided via the Internet, and hard copies were
19 provided only upon request, and that those requests were rare. At the appeals conference, petitioner
20 asserted that Mr. Bluhm's declaration should be regarded as more reliable than Mr. Thurfjell's
21 description of the optional maintenance contracts, stating that it did not know Mr. Thurfjell and that
22 petitioner's staff had never worked with him.

23 Based on its review of the invoices, the Department found that five transactions included
24 mandatory maintenance agreements based on the characterization of the charge as for "standard
25 maintenance." as being for the first year, mandatory maintenance. All of the other transactions, for
26 "software maintenance," were regarded as optional maintenance agreements for second and subsequent
27 years. One of these was a contract in 2002 and all others were in 2003 and 2004. Based on the invoice
28 descriptions of the two types of maintenance agreements, we find it was reasonable for the Department

1 to conclude that “standard maintenance” charges represented the one-year mandatory maintenance
2 contract in the absence of any evidence from petitioner to the contrary. Accordingly, we conclude that
3 there is no basis for rejecting the Department’s finding as to the mandatory maintenance agreements.

4 With respect to the optional maintenance contracts, petitioner has not provided the actual
5 contracts at issue, and it has provided no documentation other than the declaration from Mr. Bluhm to
6 show whether tangible personal property was provided in relation to those contracts, which is in
7 opposition on this point to the information from Mr. Thurfjell. Despite petitioner’s contention that we
8 should disregard the information from Mr. Thurfjell in favor of the declaration of Mr. Bluhm because
9 it did not know Mr. Thurfjell and that petitioner’s staff had never worked with him, we note that it was
10 petitioner’s president who provided Mr. Thurfjell’s name as an individual we could contact. When we
11 did telephone Mr. Thurfjell, he explained that he had worked at EMC for only about a year, beginning
12 in 2007. However, Mr. Thurfjell did not rely on his own experience with EMC, but gathered
13 information from people who had knowledge of EMC’s operations during the periods at issue, which
14 he provided to us. Further, even Mr. Bluhm’s declaration acknowledges that at least some tangible
15 personal property was transferred with optional maintenance contracts during the years 2002 through
16 2004. In the absence of specific documentation which might clarify this issue, such as copies of the
17 software maintenance contracts, we find that the weight of the evidence supports a finding that
18 petitioner transferred tangible personal property with the optional maintenance contracts for EMC
19 products, and we recommend no adjustment.

20 AMNESTY

21 Since petitioner did not participate in the amnesty program, an amnesty interest penalty of
22 \$4,419.45 will be added when the liability becomes final. Petitioner has submitted a request for relief
23 of the amnesty interest penalty, signed under penalty of perjury, on the grounds that it had no reason to
24 believe it had any amnesty-eligible tax liability because the audit was still in process on March 31,
25 2005. The Department has stated that it does not oppose petitioner’s request for relief because the
26 audit did not begin until after the March 31, 2005 deadline for applying for amnesty.

27 Petitioner does not contend that it was unaware of the amnesty program, only that it did not
28 believe it had any unreported liability for the amnesty-eligible period. We note however, that

1 petitioner's underreporting for that period was \$575,573, which is substantial. Moreover, the majority
2 of that understatement, \$533,925, is the result of reconciliation errors in petitioner's tax accrual
3 account. We find that petitioner would have discovered this substantial reporting error if it had made
4 an accounting review of its own records. Therefore, although the understatement had not been
5 identified by the Department's audit before the application deadline for amnesty, we find that
6 petitioner should have been aware that there was a significant understatement for the amnesty-eligible
7 period. Consequently, we find petitioner's failure to participate in the amnesty program was not due to
8 reasonable cause, and there is no basis to recommend relief of the amnesty interest penalty.

9 **OTHER DEVELOPMENTS**

10 None.

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