CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION FINAL ACTION SUMMARY

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of:	
SONJA M. CRAIGHTON, dba Folsom Wireless	Account Number SR KH 100-979833 Case ID 558975
Petitioner	Folsom, Sacramento County

Type of Business: Retailer of cellular phones and accessories

Liability period: 10/01/07 – 06/30/10

Item	Disputed Amount
Unreported taxable sales	$560,076
Negligence penalty	$ 4,636

Tax as determined	$55,462.33
Post-Board hearing adjustment	- 9,107.30
Tax as proposed to be redetermined	$46,355.03
Interest through 11/30/13	13,650.82
Negligence penalty	4,635.53
Total tax, interest, and penalty	$64,641.38
Payments	- 3.11
Balance Due	$64,638.27
Monthly interest beginning 12/01/13	$ 231.76

The Board held a hearing regarding this matter on January 15, 2013, granting petitioner 30 days to provide additional records and the Sales and Use Tax Department (Department) 30 days to respond. Based on petitioner's submissions and the Department's response, we recommend a reduction of $112,645 to unreported taxable sales, as explained more fully under Post Hearing Developments. The matter was then scheduled for decision on the nonappearance calendar in August 2013. Shortly before that meeting, petitioner sent a letter to the Board Members and various Board staff asserting that the Department had failed to contact her representative. The matter was removed from the August 2013 Board meeting agenda to allow time to address that concern. However, although the Department contacted petitioner's representative numerous times after receiving petitioner's letter in August 2013, no additional information or records have been provided. Therefore, no adjustments are recommended in addition to those recommended by the Department in its March 18, 2013 memorandum.

UNRESOLVED ISSUES

Issue 1: Whether adjustments are warranted to the amount of unreported taxable sales. We find no adjustment is warranted other than those described under Post Hearing Developments.

Petitioner operates an authorized MetroPCS dealership, selling unbundled cellular phones and related accessories. For review, petitioner provided federal income tax returns, sales summary reports from a computerized point of sales system (POS reports) for the liability period, and monthly accounts receivable reports. She provided no purchase or sales invoices.

The Department found that the total sales reported on petitioner's sales and use tax returns exceeded the amounts recorded in the POS reports and were substantially lower than gross receipts reported on federal tax returns. The Department compared the gross receipts and purchases reported on the federal tax returns to compute book markups of about 2 percent for 2008, 44 percent for 2009, and 25 percent for the two years combined. The Department also found that taxable sales reported on sales and use tax returns of $37,506 for 2008 and $28,704 for 2009 were substantially less than the cost of goods sold reported on federal tax returns for those years, respectively, of $114,770 and $207,349. The Department concluded that petitioner would not routinely sell devices for prices dramatically lower than costs, and it considered the book markup of 25 percent computed using the gross receipts reported on federal tax returns to be lower than expected. Since petitioner provided no purchase invoices or sales invoices, and the Department did not have information to perform a shelf test, it estimated petitioner's markup at 50 percent. The Department added that markup to the amounts of purchases reported on the federal tax returns for 2008 and 2009 to compute taxable sales, and it used those figures to compute average monthly taxable sales for the last three months of 2007 and the first six months of 2010.[1] The Department compared computed and reported taxable sales to establish unreported taxable sales of $672,721.

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[1] The Department did not make adjustments for changes in inventory because petitioner did not provide documentation to support the inventory and the ending inventory amounts appeared unreasonably high. It did not make adjustments for pilferage because the phones were kept in a secure area in a back room, making pilferage unlikely, and because petitioner's records were not sufficiently complete to ensure that all purchases were reported on federal tax returns

Petitioner asserts that the POS reports captured all sales of devices, and contends that reported taxable sales, which exceed the amounts recorded on the POS reports, are not understated. Petitioner asserts that she sells devices well below cost as an inducement for customers to sign up for utility services because she receives commissions from MetroPCS for selling its services, and she asserts that those commissions explain the substantial differences between total sales reported on sales and use tax returns and gross receipts reported on federal tax returns. However, petitioner has provided no documentation of the amount of commissions received from MetroPCS. After the appeals conference, petitioner provided two sales invoices and associated purchase invoices that show selling prices well below cost. She also provided Indirect Dealer Agreements between petitioner and MetroPCS that list suggested retail selling prices for phones. The Department compared those suggested retail prices with average costs for the same models of phones, which it established based on its prior audit experience with other MetroPCS retailers, to compute markups ranging from 30 percent to 98 percent.

Petitioner is liable for tax on her sales of wireless telecommunication devices in unbundled transactions. (Cal. Code Regs., tit. 18, § 1585, subd. (b)(2).) When a cellular phone dealer receives commissions from a service carrier in connection with sales of devices in unbundled transactions, those commissions are not taxable. However, petitioner has not provided evidence to show that any portion of the gross receipts reported on her federal tax returns represented commissions received from MetroPCS. Petitioner has not provided adequate records of her selling prices and costs from which a markup could be computed, and we find the two sets of purchase and sales invoices provided after the conference are insufficient evidence of her customary pricing policy. Further, the Department's estimated markup of 50 percent is well within the range of the markups of 30 to 98 percent the Department computed using suggested retail prices from Indirect Dealer Agreements and average costs for similar phones. In short, we find that the Department has used the best available information (purchases reported on federal tax returns and a reasonable estimated markup) to compute taxable sales, and petitioner has not provided evidence to support adjustments.

Issue 2: Whether petitioner was negligent. We conclude that she was.

The Department imposed the negligence penalty because petitioner did not provide adequate records, and the understatement was substantial. Petitioner disputes the penalty on the basis that she reported all sales of devices.

Petitioner provided records that were incomplete and conflicting. The amounts of taxable sales reported on sales and use tax returns were only a fraction of the purchases reported on federal tax returns, and the substantial amount of unreported taxable sales (after the post-Board hearing adjustments) of $560,076 represents an error ratio of 729 percent when compared to reported taxable sales of $76,793. We find that the incomplete records and the substantial understatement are clear evidence of negligence. Further, we find that any businessperson, even one with limited experience, should have recognized that her reported taxable sales of $37,506 for 2008 and $28,704 for 2009 were substantially less than the cost of goods sold reported on federal tax returns of $114,770 for 2008 and $207,349 for 2009. Accordingly, we find that the understatement was the result of negligence, and the penalty was properly applied, even though petitioner had not been audited previously.

POST BOARD HEARING DEVELOPMENTS

At the Board hearing, petitioner claimed that sales did not begin until May 2008 and asserted that an inventory adjustment should be made. The Board granted petitioner time to support the former argument, and Chairman Horton noted that the Department should consider an inventory adjustment.

After the Board hearing, in order to establish that she did not begin making sales until May 2008, petitioner provided a bank statement for the period December 15, 2008, through January 14, 2009, and a bank account summary showing that the bank account was opened on December 15, 2008. In a memorandum dated March 18, 2013, the Department found that this evidence did not establish that petitioner began making sales in May 2008. Nevertheless, the Department had concluded at the hearing, based on the depreciation schedules filed with the 2007 and 2008 federal income tax returns, that petitioner likely started business in May 2008. Accordingly, the Department changed the business start date from October 2007 to May 2008. It then deleted the established understatement of reported taxable sales for the fourth quarter 2007 and the first quarter 2008. For the remainder of 2008, the Department computed taxable sales on a markup basis and computed a percentage of error that it applied to reported taxable sales to establish the understatement. With respect to inventory, petitioner

provided no additional documentation to support the figures reported on the federal income tax returns of $48,701 for 2008 and $35,487 for 2009. Based on its audit experience, the Department considered those figures unusually high and concluded that an ending inventory of $10,000 seemed reasonable. Since the business began in May 2008, the Department found that there was an increase of inventory from zero to $10,000, and it reduced purchases for 2008 by $10,000 to compute the cost of goods sold for that year. For 2009 and 2010, the Department considered the inventory to be constant, and it used purchases as the cost of goods sold for those years. As a result of the change of the business start date to May 2008 and the adjustment for an inventory increase of $10,000 for 2008, the audited amount of unreported taxable sales was reduced by $112,465, from $672,721 to $560,076.

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

MARKUP TABLE

Percentage of taxable vs. nontaxable purchases	100%
Mark-up percentage estimated	50%
Self-consumption allowed in dollars	None
Pilferage allowed in dollars	None