

1 CALIFORNIA STATE BOARD OF EQUALIZATION

2 APPEALS DIVISION FINAL ACTION SUMMARY

3 In the Matter of the Petition for Redetermination )  
 4 Under the Sales and Use Tax Law of: )  
 5 GRAPHICS CONCEPT, INC. ) Account Number: SR AP 100-002216  
 6 ) Case ID 444651  
 7 Petitioner ) Diamond Bar, Los Angeles County

8 Type of Business: Graphic Designer

9 Audit Period: 10/1/03 – 7/31/07

<u>Disputed Item</u>	<u>Amount</u>
11 Disallowed claimed nontaxable sales	\$564,815
Unreported taxable sales	\$297,550
12 Negligence penalty	\$7,115

	<u>Tax</u>	<u>Penalty</u>
14 As determined, protested	<u>\$71,145.20</u>	<u>\$7,114.57</u>
15 Proposed tax redetermination	\$71,145.20	
Interest to 7/31/11	38,954.32	
16 Negligence penalty	<u>7,114.57</u>	
17 Total tax, interest, and penalty	<u>\$117,214.09</u>	
18 Monthly interest beginning 8/1/11	<u>\$355.73</u>	

19 Neither petitioner nor its representative appeared at the scheduled appeals conference even  
 20 though a Notice of Conference was mailed to the address of record and the Notice was not returned as  
 21 undeliverable. After the conference, which was held as scheduled in their absence, we informed  
 22 petitioner and its representative by letter that they could submit additional evidence or documents for  
 23 our consideration. They did not respond. Accordingly, we prepared our Decision and  
 24 Recommendation based upon the presentation of the Sales and Use Tax Department (Department) at  
 25 the conference and information contained in the Board’s files.

26 This matter was then scheduled for Board hearing on March 22, 2011, but neither petitioner nor  
 27 its representative responded to the Notice of Hearing. Thus, the Board Proceedings Division informed  
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SALES AND USE TAX APPEAL

1 them that the matter would be presented to the Board for decision without oral hearing. The matter  
2 was removed from the March consent calendar by Chairman Horton.

### 3 UNRESOLVED ISSUES

4 **Issue 1:** Whether adjustments to the disallowed claimed nontaxable sales are warranted. We  
5 recommend no adjustments.

6 Petitioner, a corporation, operated a graphic design business specializing in digital product  
7 imaging with related sales of catalogs and brochures, primarily to distributors of clothing, footwear,  
8 and gift items. Petitioner's services included photo shoots, artwork design and layouts. Petitioner  
9 obtained a seller's permit with a start date of January 10, 2002, and it closed out the permit effective  
10 July 31, 2007.

11 Among other claimed deductions, petitioner claimed deductions on its sales and use tax returns  
12 totaling \$564,815 for nontaxable sales for resale and nontaxable charges for conceptual design. The  
13 Department examined claimed nontaxable sales for resale on an actual basis, and disallowed those  
14 transactions not supported by a timely and valid resale certificate taken in good faith except when the  
15 sales were made to other graphic designers, which the Department assumed were sold for resale by  
16 those other graphic designers. Petitioner has not provided any sufficient credible documentation to  
17 support its contention that the disallowed transactions were, in fact, valid sales for resale, and we thus  
18 recommend no adjustment.

19 With respect to petitioner's deductions of conceptual design charges, a commercial artist's  
20 separately stated charges for preliminary art or other designation that clearly indicates the charge is  
21 solely for such preliminary services performed to convey ideas, concepts, looks, or messages to a client  
22 are not taxable provided that the artist does not transfer to the client title in or the right to permanent  
23 possession of that preliminary artwork. (Cal. Code Regs., tit. 18, § 1540, subd. (b)(1)(A)1.) The  
24 Department examined sales invoices to determine whether petitioner's charges for conceptual design  
25 were qualifying separately stated charges. During this examination, the Department found that, while  
26 the invoices described the work performed, they only stated one lump sum amount on the invoice.  
27 Therefore, the Department disallowed the claimed nontaxable conceptual design charges.  
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1 Documentation provided by petitioner does not establish that it separately stated conceptual  
2 design charges. Thus, we conclude these charges were taxable, and we recommend no adjustment.

3 **Issue 2:** Whether adjustments to the measure of additional unreported sales are warranted. We  
4 recommend no adjustments.

5 The Department compared total sales reported on sales and use tax returns and gross receipts  
6 reported on federal income tax returns and found discrepancies which petitioner explained were due to  
7 timing differences. Although the Department concluded that differences between the sales tax returns  
8 and the federal returns were likely due to timing differences, it also concluded that further examination  
9 of petitioner's reported total sales was warranted. The Department established book markups based on  
10 gross receipts and cost of goods sold reported on federal returns, resulting in markups of -8.95 percent  
11 in 2004, 67.28 percent in 2005, and 53.88 percent in 2006. The Department conducted another markup  
12 analysis, using petitioner's job folders for several customers, and established a markup of  
13 139.45 percent, which it concluded was overstated. The Department combined this markup with the  
14 book markups for 2005 and 2006 and divided the result by three to establish an audited markup of  
15 86.87 percent, which when applied to total costs of goods sold for the audit period resulted in error  
16 ratios of 184.29 percent for 2004, -39.95 percent for 2005, and 14.87 percent for 2006. The  
17 Department accepted the reported amounts for 2005 because of the negative error ratio, but projected  
18 the error ratio for the years 2004, and 2006, resulting in the additional unreported taxable sales of  
19 \$297,550.

20 Petitioner contends that it reported all sales and the unreported taxable sales established by  
21 markup were overstated.

22 We find that the markup audit methodology employed by the Department is a generally  
23 accepted method for determining total sales and for verifying the mark up obtained from a review of  
24 petitioner's records. The Department utilized petitioner's records to establish petitioner's total sales  
25 activities during the audit period. The Department also realized that the markup established through  
26 the shelf test was overstated and thus made adjustments to account for petitioner's claim that the  
27 records used in the shelf test did not include all its costs. Such adjustment to the markup benefited  
28 petitioner. Even after the adjustment to the shelf test markup was made, application of the adjusted

1 markup to audited cost of goods sold still resulted in additional unreported taxable sales. Petitioner has  
2 not provided any evidence to support its argument that all sales had been reported. Thus, we  
3 recommend no adjustments.

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

5 The Department imposed the negligence penalty because petitioner underreported its taxable  
6 sales by \$862,365, which is significant when compared to reported taxable sales of \$600,873, and  
7 petitioner failed to maintain adequate records to support its claimed nontaxable sales. Petitioner argues  
8 that the penalty should not apply because this was petitioner's first audit and it was not negligent in  
9 reporting or recordkeeping.

10 Although this was petitioner's first audit, the fact that it underreported its taxable sales by  
11 144 percent ( $\$862,365 \div \$600,873$ ), combined with its failure to maintain adequate records in the form  
12 of resale certificates, is sufficient to establish negligence in this case. Accordingly, we find that  
13 petitioner was negligent and the negligence penalty was properly imposed.

14 **OTHER DEVELOPMENTS**

15 None.

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