

UNRESOLVED ISSUES

1
2 **Issue 1:** Whether adjustments are warranted to the disallowed claimed nontaxable and netted
3 sales. Based on our first post-hearing review, we found that a reduction to this item is warranted, but
4 that this reduction is fully offset by other adjustments, as discussed under Post Hearing Developments.
5 Therefore, we recommend no adjustment.

6 Petitioner sold software for website design until its merger with Adobe Systems, Inc. on
7 December 31, 2005. Petitioner delivered software to its customers both electronically and on compact
8 discs. The only records petitioner provided to the Sales and Use Tax Department (Department) for
9 audit were copies of the sales and use tax returns, a computer file of petitioner's sales with "ship to"
10 addresses in California during the period May 2004 through December 2005 ("recorded sales"), and
11 resale certificates. Petitioner did not provide purchase records, sales invoices, credit memos,
12 customer's purchase orders, or any other records.

13 To establish the audited understatement of reported total sales, the Department compared
14 recorded and reported total sales for complete quarters only. Petitioner's recorded total sales for the
15 period July 1, 2004, through December 2005, were \$80,864,847. For the same period, petitioner
16 reported total sales of \$72,368,876, an understatement of \$8,495,971, or 11.74 percent. The
17 Department did *not* separately assess tax on this understatement; rather, this amount was used in the
18 calculation of incorrectly claimed or netted nontaxable sales.

19 To establish the amounts of error in claimed nontaxable and netted sales, the Department began
20 by segregating the recorded sales for the entire period for which petitioner provided a computer file,
21 May 1, 2004, through December 31, 2005, into three populations: 1) sales invoices with a line item for
22 freight; 2) sales invoices without a line item for freight and with a tax code of exempt; and 3) sales
23 invoices without a line item for freight and without a tax code of exempt. It then separated each
24 population into three strata. For each population, the Department reviewed stratum 3 (the largest sales)
25 on an actual basis and chose random samples of transactions for review from strata 1 and 2. For
26 population 1, the Department computed percentages of error of 1.02 percent for stratum 1 and
27 1.57 percent for stratum 2, and found errors totaling \$603,775 in its review of stratum 3 on an actual
28 basis (\$6,081 for errors in May and June 2004 and \$597,694 for errors during the period July 1, 2004,

1 through December 31, 2005). The Department found no errors in population 2. The Department
2 found nine errors in population 3 (one in stratum 2 and eight in stratum 3), which totaled \$15,802
3 (\$3,038 for an error in June 2004 and \$12,764 for errors during the period July 1, 2004, through
4 December 31, 2005).

5 The Department then computed the overstatement of claimed nontaxable and netted sales for
6 the test period (July 1, 2004, through December 31, 2005). It established the total amounts of strata 1
7 and 2 of population 1, and applied the percentages of error of 1.02 percent and 1.57 percent,
8 respectively. It then added the errors it found on an actual basis of \$597,694 for stratum 3 of
9 population 1 and \$12,764 for strata 2 and 3 of population 3. The Department computed a total
10 disallowed claimed nontaxable and netted sales for the test period of \$728,470.

11 The Department then calculated a percentage of error of 0.762 by comparing the \$728,470
12 measure of errors to the \$95,575,785 of sales recorded for the period May 1, 2004, through
13 December 31, 2005. We note that, since the measure of error was derived from the period July 1,
14 2004, through December 31, 2005, and was compared to total receipts from that same period *plus* the
15 total receipts from the two prior months, the Department's method of calculation understates the
16 percentage of error (to petitioner's benefit).

17 For the earlier part of the audit period, July 1, 2003, through June 30, 2004, petitioner reported
18 total sales of \$29,474,880. To calculate audited total sales, the Department regarded petitioner as
19 having underreported total sales during this period in the same percentage as for the later period for
20 which petitioner provided records, that is, 11.74 percent. Applying that percentage understatement to
21 reported sales, the Department calculated audited total sales of \$32,935,176. The Department then
22 applied the 0.762 percentage of error for disallowed claimed nontaxable and netted sales calculated for
23 the later period to compute disallowed claimed nontaxable and netted sales of \$251,029, for a total of
24 \$979,499 for the entire audit period.

25 Of the sales claimed or netted as nontaxable which the Department regarded as subject to tax,
26 petitioner disputes only the disallowed (on an actual basis) claimed and netted nontaxable sales of
27 \$395,141 to California State University, office of the Chancellor (CSU). Petitioner asserts the sales to
28 CSU were sales of software delivered electronically. Petitioner had sent out inquiry letters to

1 customers for transactions questioned by the Department, and relied on CSU's response to the letter
2 sent to it as well as on an undated letter from a CSU employee stating that CSU did not receive any
3 tangible media.

4 The agreement between CSU and petitioner does indicate that there would be an electronic
5 delivery of the software, but also provides that a master copy of the software on storage media would
6 be shipped to CSU. For the disputed transactions, the Department regarded shipment of tangible
7 personal property under this contractual provision as confirmed by the file download provided by
8 petitioner, which contains a line item for a compact disc and a corresponding freight charge or
9 warehouse shipment location (or both) for these transactions. It appears possible that the compact disc
10 was transferred for backup purposes, and that the customer regarded the transaction as primarily an
11 electronic transfer of the software. Nevertheless, we conclude that the record shows the transaction
12 also included the transfer of the software in tangible form. Whether that transfer of tangible media was
13 for backup purposes or for the primary distribution of the software is irrelevant: where petitioner
14 transferred the software on tangible media (in addition to any electronic transfer), it made a taxable
15 sale of tangible personal property. At the time of the hearing, we found that no adjustment was
16 warranted to the determination for these three transactions.

17 Petitioner's other dispute regarding the Department's calculation of disallowed claimed and
18 netted resales is that the Department applied the percentage of error of 0.762 for disallowed claimed
19 nontaxable and netted sales to recorded sales (and for the earlier portion of the audit period, reported
20 sales increased by the error factor of 11.74 percent developed from the later portion of the audit
21 period), rather than applying that percentage of error to reported sales.

22 Petitioner explains the discrepancy between recorded and reported sales as the result of
23 transactions recorded as sales but never consummated, including holds, voids, and quotes that never
24 materialized into actual sales. Petitioner asserts that its switchover to different software after the
25 merger impaired its ability to properly filter the transactions included in the computer file given to the
26 Department. However, petitioner has not provided credit memos, voided invoices, quote sheets, or any
27 other specific evidence to show that any of the recorded sales in the computer file do not represent
28 consummated sales. Instead, petitioner relies on the fact that some persons responded to the inquiry

1 letters it sent by indicating that the questioned transactions had never taken place. Specifically,
2 petitioner states that of the 36 responses to those letters, representing recorded sales of \$1,687,857,
3 seven indicate that the sales had never occurred, representing recorded sales of \$145,380.¹ Based on
4 these figures, petitioner calculates two possible percentages for unconsummated transactions included
5 in its recorded sales: 8.61 percent ($\$145,380 \div \$1,687,857$) and 19.44 percent ($7 \div 36$). That is,
6 petitioner asserts that responses to letters sent to a portion of its customers (i.e., only to persons shown
7 in its records as having made nontaxable purchases where the Department questioned the
8 nontaxability), should be regarded as representative on this issue for *all* of the transactions it recorded
9 in its records, including those recorded as taxable. We do not accept these responses as representative
10 for the purpose asserted by petitioner. We note, in this regard, that every response that indicated the
11 transaction did not occur was accepted as having been properly regarded as not taxable. In the absence
12 of credit memos, voided invoices, quote sheets, or any other specific evidence *at all*, we do not find the
13 responses on which petitioner relies to show that *any* of the transactions recorded as sales in the
14 computer file do not represent consummated sales.

15 Petitioner also contends it is improbable it would have such a large amount of disallowed
16 claimed and netted nontaxable sales because petitioner is a publicly traded company, regulated by both
17 the SEC and the Sarbanes-Oxley Act, and is audited quarterly by a public accounting company. We
18 find that the fact petitioner is regulated and audited quarterly is wholly irrelevant to the issue of
19 whether it correctly reported its California sales for sales and use tax. The quarterly audit petitioner
20 relies on is not an audit for purposes of determining if petitioner properly reported sales and use tax.
21 Even if the audit included a determination of petitioner's total sales, and even if that amount were
22 correct, petitioner could have made errors in reporting California sales and use tax which would not
23 have been examined during an audit for other purposes.(e.g., an error in allocating the sales among the
24 various states, or segregating the taxable and nontaxable sales). In that regard, we note that the
25 information the Department relied on was net of sales that petitioner's records showed as shipped to

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27 ¹ We count 46 responses, six of which indicate that the invoices did not represent consummated sales. We have not
28 attempted to reconcile these differences.

1 customers in other states. Such sales delivered from California were required to be reported on line 1
2 of petitioner's returns, and, if qualifying for exemption, deducted as appropriate. Had petitioner
3 reported correctly, the Department presumably would have tested the claimed exempt interstate sales
4 to ensure that they were claimed properly. However, the Department effectively accepted all such
5 sales as exempt sales without any review since it included no deficiency for sales which were neither
6 reported nor recorded (i.e., netted from both returns and records, such as all sales which reflected out-
7 of-state delivery addresses).

8 **Issue 2:** Whether adjustments are warranted to the audited amount of recorded, but not
9 reported, taxable sales. We find no basis for an adjustment to decrease the deficiency for this item (see
10 Post Hearing Developments for a discussion of an error in petitioner's favor).

11 The computer file petitioner provided the Department reflected accrued sales tax of \$709,936
12 for the period July 1, 2004, through December 31, 2005. For the same period, petitioner reported sales
13 tax of \$671,653, which is \$38,283 less than it recorded, for an error rate of 5.7 percent. The
14 Department applied that percentage of error to the amount of sales tax reported for the remainder of the
15 audit period to calculate the additional understatement of reported tax for that period of \$18,000, for a
16 total understatement of recorded sales tax of \$56,283. Based on this amount, the Department
17 calculated the associated taxable measure that had been recorded, but not reported, of \$649,488.²

18 As discussed under Issue 1, petitioner contends the amount of sales recorded in the computer
19 file includes transactions that were never consummated. We find petitioner's arguments on this point
20 even less convincing in the context of transactions for which petitioner's records shows tax
21 reimbursement was collected. Petitioner has not provided sales invoices, credit memos, quote sheets,
22 or any similar records to substantiate its contention that some of the recorded tax reimbursement was
23 never actually charged and collected. Nor has petitioner provided any other records from which the
24 Department could establish such amounts collected by petitioner except for the records provided in the
25 computer file that show petitioner collected tax reimbursement of \$709,936 for the period July 2004
26 through December 2005, during which period petitioner reported sales tax of \$671,653. The burden is

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28 ² This is the calculation that was in error, discussed below.

1 on petitioner to establish the taxable sales listed in its own records were not actual sales, and it has
2 failed to show that such is the case.

3 **Issue 3:** Whether adjustments are warranted to the understated amount of ex-tax purchases
4 subject to use tax. We recommend no adjustment.

5 Petitioner did not provide purchase records for use by the Department in verifying the accuracy
6 of petitioner's recorded purchases subject to use tax, so the Department used information from its audit
7 of the period January 1, 2000, through December 31, 2002, to calculate the taxable percentage of
8 petitioner's purchases. During that prior audit period, petitioner reported purchases subject to use tax
9 equal to 6.558 percent of its reported total sales, while in the current audit period it reported purchases
10 subject to use tax equal to 1.188 percent of its reported total sales. The Department concluded that
11 petitioner's reported purchases subject to use tax were understated. Petitioner's reported measure of
12 use tax during the last year of the prior audit equaled 2.567 percent of its total reported sales for that
13 year. The Department compared this percentage to the 1.188 percent that petitioner's reported measure
14 of use tax bore to its total reported sales to calculate an understatement equal to 1.379 percent of
15 reported total sales.

16 Petitioner contends that there was no understatement of reported purchases subject to use tax.
17 Petitioner notes that the Department did not find errors in reported purchases subject to use tax in three
18 prior audits. Petitioner contends that its sales were independent of its purchases, and the use of a
19 percentage of purchases subject to use tax to total sales is not practical. Further, petitioner contends
20 that the audited amount of purchases subject to use tax does not account for the fact that, during the
21 audit period at issue, petitioner was preparing to close or sell its business, which resulted in a decrease
22 of purchases.

23 In our prior summary, we noted that petitioner's arguments are logical and seem, on the
24 surface, to support its contention that there was no understatement of use tax. However, we also
25 observed that petitioner had provided no purchase records whatsoever that the Department could use to
26 evaluate the accuracy of reported amounts. Since the D&R did not clearly set forth the difficulty of
27 evaluating this matter, we provided additional explanation in the prior summary.

1 Petitioner was previously audited three times, for the period January 1, 1992, through
2 March 31, 1995, for the period October 1, 1995, through September 30, 1998, and for the period
3 January 1, 2000, through December 31, 2002. In the first audit, the Department did not examine
4 petitioner's purchase invoices, but the audit workpapers noted that the auditor had worked with
5 petitioner to develop a method for identifying and recording use tax liability in the future. In the next
6 audit, the Department conducted a spot test and discovered no errors in reported purchases subject to
7 use tax. In the most recent prior audit, the Department reviewed petitioner's purchase invoices for the
8 test period April 1, 2001, through March 31, 2002, and found that purchases subject to use tax had
9 been properly reported.

10 The audit period at issue here (July 1, 2003, through December 31, 2005) begins about one year
11 after that test period. Thus, the test in the prior audit is close in time to the current audit period and
12 might be regarded as an indication that petitioner's reported purchases subject to use tax in the current
13 audit period also may be reliable. However, we also find that the Department's method for calculating
14 the use tax deficiency is logical and supportable. Petitioner was required to maintain records and
15 present them for audit, but it did not do so, presenting no records *at all* of purchases for this audit
16 period. Petitioner's arguments do not establish that it made no mistakes in reporting use tax. In the
17 prior summary, we concluded, based on the complete lack of purchase records, that petitioner has
18 failed to provide evidence that the Department's conclusion is incorrect or from which a more accurate
19 determination may be made, and we recommend no adjustment. We again addressed the issue of use
20 tax after the Board considered this matter in November 2010, as discussed under "Post Hearing
21 Developments."

22 POST HEARING DEVELOPMENTS

23 After the Board hearing on March 24, 2010, petitioner provided additional documentation and
24 explanation to support its contention that three sales of software to CSU were nontaxable sales of
25 software delivered electronically without any transfer of tangible personal property. Upon
26 consideration of the additional documentation and arguments and explanations provided, we found that
27 the \$24,737.00 measure of tax assessed on one of those sales should be regarded as nontaxable and that
28 a portion of another sale, measured by \$7,754.00, should be regarded as nontaxable. We found that no

1 adjustment was warranted with respect to the third disputed transaction. Thus, we concluded that the
2 measure of deficiency for this item should be reduced by \$32,491.00. However, the Department had
3 identified two errors in the audit that were in petitioner's favor, which fully offset the adjustment
4 related to the sales of software to CSU. One of the errors was made when translating the difference in
5 tax recorded and reported into a measure. In doing so, the Department understated petitioner's error by
6 a measure of \$38,014, and this lower measure was used in the calculation of the determination issued
7 to petitioner. Since this error measured by \$38,014.00 fully offset the over-assessment measured by
8 \$32,491.00, we recommended that the petition be denied without adjustment.

9 After the Board considered this matter on November 17, 2010, Board member Steel noted an
10 apparent discrepancy between our conclusions regarding the application of tax to two sales to CSU,
11 which were represented by invoices #1438331 and #1332640. Specifically, Board member Steel noted
12 that, while neither of the invoices included a separate reference to a shipment of compact disks, we had
13 concluded that the sale represented by invoice 1438331 was subject to tax and found that the sale
14 represented by invoice 1332640 was nontaxable. We first note that, in our review of sales to CSU, we
15 concluded that the sales included compact disks if there was a separate line item showing compact
16 disks or if the invoice either included a charge for freight or listed a BOL (assumed to represent bill of
17 lading) number. In reviewing the two sales addressed by Board Member Steel, we found that neither
18 of the sales invoices shows a separate line-item for compact disks, and both of the invoices include a
19 freight charge and a BOL number. Thus, based on our general analysis, we would find both of the
20 sales to be taxable. However, on its review of invoice #1332640, CSU noticed that the freight charge
21 was in error and requested a refund. Once the freight charge had been refunded, we concluded there
22 was no evidence of a transfer of tangible personal property with that sale. Since CSU did not request a
23 refund of the freight charge included with invoice #1438331, we find that the facts surrounding these
24 two invoices are not similar, and there is no inconsistency in our finding that one sale was taxable and
25 the other was not.

26 Next, in response to Board Member Steel's request, we contacted petitioner requesting
27 supporting documentation to show that the reported amount of ex-tax purchases subject to use tax was
28 correct. In response, petitioner provided its sales and use tax report (run from its internal system), its

1 sales and use tax returns, and the use tax accrual report, which show that the accrued use tax matches
2 the reported amount of ex-tax purchases subject to use tax. However, petitioner has not provided
3 purchase journals and accompanying purchase invoices for the Department to verify whether the
4 *recorded* amounts of accrued use tax are correct. Therefore, while we (and the Department) agree that
5 the method used might not have been the best way to establish the unreported amount of purchases
6 subject to use tax, the Department has used the best evidence available to determine the underreported
7 amount. (See Sales and Use Tax Audit Manual section 0405.33.)

8 Thus, although petitioner's contentions appear logical, and it is plausible that there may have
9 been no understatement of use tax, petitioner has provided no purchase records whatsoever that the
10 Department could use to evaluate the accuracy of reported amounts. Moreover, regarding petitioner's
11 argument that it was preparing to close its business, we find that the audit *does* account for that change
12 in business operations by using the 2.567 percent figure calculated for the last year of the prior audit
13 rather than the 6.558 calculated for the entire three years of the prior audit period.³ We therefore
14 conclude, based on the complete lack of purchase records, that petitioner has failed to provide evidence
15 that the Department's conclusion is incorrect or information from which a more accurate determination
16 may be made. Thus, we have no basis on which to recommend any reduction to the measure of tax for
17 this audit item.

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20 Summary prepared by Deborah A. Cumins, Business Taxes Specialist III
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27 ³ As noted above, it is undisputed that petitioner merged with Adobe Systems, Inc. (Adobe), and therefore we note that
28 petitioner may have continued operations as a division of Adobe and may have continued to consume tangible personal
property in this state.

Statistical Sample

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2	Transactions Examined	Nontaxable Sales
3	Confidence level	80%
4	Confidence interval	8.128%*
5	Total number of items in the population	9,559 for stratum 1 2,312 for stratum 2 268 for stratum 3
6	Number of items randomly selected for the test	500 for stratum 1 300 for stratum 2 268 for stratum 3
7	Number of errors found	8 for stratum 1 8 for stratum 2 26 for stratum 3)
8		
9	Whether stratification was used, and if so what was stratified	Stratified by sales amount \$100 - \$1000 \$1000.01-\$10,000 Greater than \$10,000
10		
11	Average dollar value of population	\$383 for stratum 1 \$2,532 for stratum 2 \$32,522 for stratum 3
12		
13	Dollar value of remaining errors	\$1,942 for stratum 1 \$12,316 for stratum 2 \$603,775 for stratum 3
14		
15	Dollar value of sample	\$191,096 for stratum 1 \$783,721 for stratum 2 \$8,715,818 for stratum 3
16		
17	Percentage of error	1.02% for stratum 1 1.57% for stratum 2 Actual basis for stratum 3
18		
19	Were XYZ letters sent (i.e., inquiry letters to purchasers)	yes
20	Number of XYZ letters sent	57
21	Percentage of XYZ letters sent in relation to number of tested items	7%**
22	Number of responses to XYZ letters received	46**
23	Percentage of responses to XYZ letters received in relation to the number of XYZ letters sent	81%
24	Number of responses to XYZ letters received accepted as proof of valid nontaxable sales	38
25	Percentage of responses to XYZ letters received accepted as proof of valid nontaxable sales	83%
26	Number of responses to XYZ letters treated as taxable	8
27	Percentage of responses to XYZ letters treated as taxable	17%

*The Department computed one confidence interval for the stratified random sample, as a whole.

**It is not clear from the audit workpapers whether one XYZ letter was sent when there was more than one invoice to the same customer. Accordingly, the percentage of 7% is an estimate. This may also be the reason that we counted 46 responses to XYZ letters while petitioner states there were 36 responses.