

1 CALIFORNIA STATE BOARD OF EQUALIZATION

2 APPEALS DIVISION SUMMARY FOR BOARD HEARING

3 In the Matter of the Petitions for Redetermination)
4 and the Claim for Refund Under the Sales and)
5 Use Tax Law of:)

6 SANDISK CORPORATION)

Account Number: SR GH 26-814758

) Case ID's 208950, 225448, 312943

7 Petitioner)

Milpitas, Santa Clara County

8 Type of Business: Manufacturer of flash data storage products

9 Liability Periods: 10/1/99 – 3/31/00 (208950)
4/01/00 – 12/31/01 (225448)

10 Claim Period: 10/1/99 – 12/31/01 (312943)

11 ItemAmounts in Dispute12 Inventory withdrawals \$1,946,707 (208950, 312943)
13 \$5,609,424 (225448, 312943)14 208950225448TaxTaxTotal

15 As determined \$188,095.31 \$569,616.05 \$ 757,711.36

16 Adjustment: Sales and Use Tax Department + 42,199.72¹ + 42,199.72

17 Proposed redetermination \$230,295.03 \$569,616.05 \$ 799,911.08

18 Concurred in - 71,967.06 - 113,394.99 - 185,362.05

18 Protested \$158,327.97 \$456,221.06 \$ 614,549.03

19 Proposed tax redetermination \$230,295.03 \$569,616.05 \$ 799,911.08

Interest through 5/26/05 86,871.17 204,766.12 291,637.29

20 Total tax and interest \$317,166.20 \$774,382.17 \$1,091,548.37

20 Payments -317,166.20 -774,382.17 -1,091,548.37

21 Balance due \$ 0.00 \$ 0.00 \$ 0.00

22 These matters were originally scheduled for Board hearing on December 17, 2008, but were
23 postponed because petitioner's representative needed time to review some newly found information
24 and requested that the matters be rescheduled for the March 2009 Sacramento Board meeting.25
26
27 ¹ The Notice of Determination was issued based on an estimate to prevent the statute of limitations from barring issuance of
28 the notice. When the audit was completed, the Sales and Use Tax Department determined that more tax was due than
indicated in the Notice of Determination, and it therefore issued a letter dated August 28, 2003, asserting the increase
pursuant to Revenue and Taxation Code section 6563.

UNRESOLVED ISSUE

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2 **Issue:** Whether petitioner has established that adjustments are warranted to the measure of
3 inventory withdrawals subject to use tax. We recommend no adjustments to the determinations and
4 that the claim for refund of amounts paid per the determinations be denied.

5 Petitioner is a designer, manufacturer, and supplier of flash data storage products used in digital
6 cameras and other electronic equipment, with the majority of its sales being at wholesale to retailers
7 and to original equipment manufacturers. As part of its operations, petitioner conducts quality control
8 testing by having its engineers pull materials from resale inventory. Engineers filled out Material
9 Transfer Issue forms upon removing materials from resale inventory and Material Transfer Return
10 forms to return materials to resale inventory. The request forms contained the quantity and part
11 number of the material transferred, and the department and account number involved in the transfer.
12 Petitioner indicates that it could be several weeks or several months between the removal of materials
13 from and the return of those materials to resale inventory. However, if the materials were damaged or
14 found to be defective during testing, they were destroyed and not returned to resale inventory.
15 Petitioner claims that about 95 percent of materials removed from inventory for testing during the audit
16 period were returned to resale inventory with no intervening use.

17 To calculate its potential use tax liability, petitioner states that it manually made debit entries on
18 a material-transfer spreadsheet to account for the amount of materials removed from inventory, and
19 credit entries (“de-accruals”) to account for the amount of materials returned to inventory. At the end
20 of each month, petitioner made manual journal entries based on the aggregate of debit and credit entries
21 to the use tax accrual account from the material transfer spreadsheets.

22 The Sales and Use Tax Department (Department) conducted an audit for the period January 1,
23 1999, to December 31, 2001, but did not issue a determination prior to the expiration of the time to do
24 so for the period January 1, 1999, through September 30, 1999. The Department issued two
25 determinations covering the remaining period, October 1, 1999, through December 31, 2001. During
26 the audit, the Department reviewed credit entries that reduced the accrued use tax. The Department
27 examined seven accounts with credits totaling \$8,621,115.92 that represented over 50 percent of the
28 \$14,769,169.86 in total recorded credit entries for the audit period. The Department found that

1 petitioner made credit entries on the spreadsheets with no reference to debit entries being reversed.

2 The Department also found that petitioner made credit entries on a sizable amount of material returned
3 to resale inventory of a different type than those for which debit entries were made. That is, the serial
4 numbers on many of the materials allegedly returned to inventory were not the same numbers as those
5 belonging to the inventory items that were withdrawn from inventory. The Department allowed credit
6 entries when the material serial number and amount could be reconciled with the number and amount
7 withdrawn from resale inventory. The Department disallowed credit entries if material item numbers
8 for returns did not match the numbers withdrawn from inventory or if the amount of materials returned
9 exceeded the amount of materials withdrawn.

10 Based on examining the seven accounts, the Department found \$5,401,245 in unsupported
11 credits and calculated a 62.65 percent error rate ($\$5,401,245 \div \$8,621,116$). Applying this error rate to
12 the total recorded credits for the audit period resulted in unsupported claimed credits of \$9,253,078 for
13 the audit period. The Department adjusted the unsupported claimed credits for allowable credits and
14 amounts for the expired period of January 1, 1999 through September 30, 1999. In sum, the
15 Department established \$1,946,707 for the period October 1, 1999, through March 31, 2000, and
16 \$5,609,424 for the period April 1, 2000, through December 31, 2001, for a total of \$7,556,131 of
17 disallowed credits because supporting documentation was not available to show that use tax was
18 accrued on these resale inventory withdrawals.

19 Petitioner claims that it systematically and routinely made debit entries to accrue use tax when
20 materials were removed and made credit entries when materials were returned. Petitioner claims that
21 the amount of resale inventory withdrawn for testing often exceeded the amount required and, if no use
22 was made of the material, petitioner returned the material to inventory. Petitioner describes the
23 removal process as a closed-loop system and asserts that all returned materials originated from resale
24 inventory and triggered a use tax accrual upon removal from inventory. Petitioner also claims that the
25 Department's inability to trace returned material back to the removal date, amount, and number does
26 not negate the fact that petitioner's inventory control system was designed to record use tax at the
27 moment of inventory removal. Petitioner also argues that the engineering department could only
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1 receive materials with use tax accrued via the inventory control system and any subsequent
2 bookkeeping entries did not alter or change the potential tax accrual basis of the returned materials.

3 In order to establish that it is entitled to the claimed credits, petitioner has to prove that credits
4 were taken only for those materials for which tax or tax reimbursement had been paid to vendors or tax
5 had been accrued and paid to the state. However, petitioner has not provided sufficient credible
6 evidence, such as traceable material transfer requests, to verify that it accrued and paid use tax on the
7 removal of all materials from inventory for which it claimed credits as returned to inventory (or to
8 verify that it remitted tax or tax reimbursement to its vendors upon purchase of the materials). Thus,
9 on this basis, we recommend no adjustment.

10 Petitioner suggests that there are several reasons why the Department could not trace certain
11 materials: (1) some inventory material did not have a unique identifier other than the part number (i.e.,
12 there were no item-by-item serial numbers); (2) there were intervening changes to an employee's
13 department number which determines the department to which the material was charged; (3) material
14 may have been pulled from inventory by an employee in one department and returned by a different
15 employee in another department; (4) material may have been pulled by an employee who failed to
16 return it to the specific account or department number from which the material was withdrawn; (5) the
17 finance department may have reclassified materials and changed the department number and/or
18 account number charged; (6) materials may have been withdrawn and constructed into a sub-assembly
19 with a completely different number; (7) the material may have been purchased directly into an expense
20 account; and (8) numbers may have changed as materials move through the system and evolve from
21 inventory, to subassembly, to assembly, to finished product.

22 We conclude that petitioner's suggestions are merely conjecture and speculation without
23 credible evidence that shows these possibilities actually occurred with respect to a significant number
24 of disallowed credit entries. Without any identification and evidence to prove that these alleged
25 transactions are not subject to tax, there is no basis to recommend an adjustment.

26 Petitioner contends that it overpaid tax on inventory shipped to its locations outside California
27 where petitioner may or may not have made a taxable use of inventory. Petitioner notes that although
28 it has not identified the specific department or occurrence of the alleged out-of-state use, it is certain

OTHER DEVELOPMENTS

In addition to the adjustments recommended in the reaudit discussed above (for which petitioner did not allow the reaudit), we also recommended an adjustment based on removing transactions during the period prior to October 1, 1999, from the test to calculate the percentage of error since that period was not included in the determined period of liability. This calculation resulted in an *increase* to the percentage of error; from 62.65 percent to 64.27 percent, but the Department has not asserted an increase to the deficiency as a result.

None.

Summary prepared by Rey Obligacion, Business Taxes Specialist III