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SALES AND USE TAX APPEAL

CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION SUMMARY FOR BOARD HEARING

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of:	
MACROMEDIA, INC.	Account Number: SR BH 99-152721 Case ID 461946
Petitioner	San Jose, Santa Clara County

Type of Business: Website design software

Audit period: 7/01/03 – 12/31/05

Item	Disputed Amount
Disallowed claimed nontaxable and netted sales	$ 740,805
Difference b/w recorded and reported taxable sales	$ 649,488
Purchases subject to use tax	$1,404,426

Tax as determined and proposed to be redetermined:	$244,717.54
Less concurred	19,256.40
Balance, protested	$225,461.14
Proposed tax redetermination	$244,717.54
Interest through 9/30/08 (tax paid in full on 9/24/08)	84,641.26
Total tax and interest	$329,358.80
Payments	244,717.54
Balance Due	$ 84,641.26

UNRESOLVED ISSUES

Issue 1: Whether adjustments are warranted to the disallowed claimed nontaxable and netted sales. We recommend no adjustment.

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

To establish the audited understatement of reported total sales, the Department compared recorded and reported total sales for complete quarters only. Petitioner's recorded total sales for the period July 1, 2004, through December 2005, were $80,864,847. For the same period, petitioner reported total sales of $72,368,876, an understatement of $8,495,971, or 11.74 percent. .

To establish the amounts of error in claimed nontaxable and netted sales, the Department began by segregating the recorded sales for the entire period for which petitioner provided a computer file, May 1, 2004, through December 31, 2005, into three populations: 1) sales invoices with a line item for freight; 2) sales invoices without a line item for freight and with a tax code of exempt; and 3) sales invoices without a line item for freight and without a tax code of exempt. It then separated each population into three strata. For each population, the Department reviewed stratum 3 (the largest sales) on an actual basis and chose random samples of transactions for review from strata 1 and 2. For population 1, the Department computed percentages of error of 1.02 percent for stratum 1 and 1.57 percent for stratum 2, and found errors totaling $603,775 in its review of stratum 3 on an actual basis ($6,081 for errors in May and June 2004 and $597,694 for errors during the period July 1, 2004, through December 31, 2005). The Department found no errors in population 2. The Department found nine errors in population 3 (one in stratum 2 and eight in stratum 3), which totaled $15,802 ($3,038 for an error in June 2004 and $12,764 for errors during the period July 1, 2004, through December 31, 2005).

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

The Department then calculated a percentage of error of 0.762 by comparing the $728,470 measure of errors to the $95,575,785 of sales recorded for the period May 1, 2004, through December 31, 2005. We note that, since the measure of error was derived from the period July 1, 2004, through

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December 31, 2005, and was compared to total receipts from that same period *plus* the total receipts from the two prior months, the Department's method of calculation understates the percentage of error (to petitioner's benefit).

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

Petitioner contends that the disallowed claimed and netted nontaxable sales during the test period to California State University, office of the Chancellor (CSU), which total $395,141, were not subject to tax because the software was delivered electronically.[1] In support, petitioner provided CSU's response to an XYZ letter indicating that all software was delivered by petitioner to CSU electronically. Petitioner also presented an undated letter from a CSU employee stating that CSU did not receive any tangible media.

The Agreement between CSU and petitioner indicates that the software would be delivered electronically. However, it also indicates that, for the software licenses sold, petitioner would ship one master copy to CSU. Also, the computer file of recorded sales contains a line item for a compact disc and a corresponding freight charge and/or a warehouse shipment location for the transactions at issue. It appears possible that the compact disc was transferred for backup purposes, and that the customer regarded the transaction as primarily an electronic transfer of the software. Nevertheless, we conclude that the record shows the transaction also included the transfer of the software in tangible form. Whether that transfer of tangible media was for backup purposes or for the primary distribution of the

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[1] The D&R addresses this separately as Issue 4 ("<u>Electronic Delivery of Sales</u>"), but we include it here because these transactions were disallowed as part of disallowed claimed nontaxable and netted sales.

software is irrelevant: petitioner transferred the software on tangible media (in addition to any electronic transfer) and thus made a taxable sale of tangible personal property.

In addition to the sales to CSU, there were $238,694 other sales during the test period that were recorded as nontaxable and found by the Department to be taxable, but petitioner has not disputed the Department's findings as to any of these other transactions. Nor has petitioner indicated any disagreement with the percentages of error computed for strata 1 and 2 of population 1. However, petitioner does not agree that its recorded sales during the test period should be regarded as audited total sales for that period, as the Department has done, and contends that its recorded sales should be reduced for unconsummated sales before the error rates are applied to strata 1 and strata 2 of population 1. Petitioner also disputes the increase of its reported total sales for the period July 1, 2003, through June 30, 2004, by 11.74 percent (the reporting error determined for the later portion of the audit period), contending that the percentage of disallowed claimed nontaxable and netted sales of 0.762 percent should be applied only to the reported sales.

Petitioner contends that its recorded sales exceed the actual amount of sales for the period May 1, 2004, through December 31, 2005, because the recorded amounts include holds, voids, and quotes that never materialized into actual sales. Petitioner asserts that its switchover to different software after the merger impaired its ability to properly filter the transactions included in the computer file given to the Department. However, petitioner has not provided credit memos, voided invoices, quote sheets, or any other specific evidence to show that any of the recorded sales in the computer file do not represent consummated sales. Instead, petitioner relies on the fact that some customers responded to XYZ letters by stating that the questioned transactions had never taken place. Specifically, petitioner states that of the 36 responses to the XYZ letters, representing recorded sales of $1,687,857, seven indicate that the sales had never occurred, representing recorded sales of $145,380.[2] Based on these figures, petitioner calculates two possible percentages for unconsummated transactions included in its recorded sales: 8.61 percent ($145,380 ÷ $1,687,857) and 19.44 percent (7 ÷ 36). We

[2] By our count, 46 XYZ letters were returned, and the responses indicate that six of the invoices did not represent consummated sales. We have not attempted to reconcile these differences.

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note that petitioner has not contended that reported total sales were overstated. In fact, the specific wording of petitioner's explanation of its argument, in a May 5, 2009 email is, "In conclusion, using either method, Auditor's data and the XYZ letter responses we would like to prove that the dollar amount of total non-existing invoices comes near the amount of what the Auditor is saying was under-reported by Taxpayer." Our understanding of this explanation is that petitioner contends reported figures were correct, and it has computed the percentages of overstatement of 8.61 percent and 19.44 percent simply to illustrate that the percentage of alleged unconsummated sales identified in the XYZ responses is comparable to the 11.74 percent of difference between recorded and reported total sales.

In the absence of credit memos, voided invoices, quote sheets, or any other specific evidence *at all* to show that *any* of the transactions recorded as sales in the computer file do not represent consummated sales, we do not find the XYZ responses to be convincing. For example, a customer who receives an XYZ letter years after a sale occurred may not have any records of that transaction and could mistakenly respond that the sale did not occur. Had petitioner provided *any* other documentation that some of the transactions it recorded as sales were voided or were not consummated sales, we would be more inclined to accept customer responses that sales did not occur, even if more customers so responded than the specific documentation of such unconsummated sales provided by petitioner. However, since there is absolutely no evidence, other than the seven responses to XYZ letters, that petitioner's *own* records do not accurately reflect its sales, we find there is no basis for adjustment of audited total sales.

Petitioner also contends it is improbable it would have such a large amount of disallowed claimed and netted nontaxable sales because petitioner is a publicly traded company, regulated by both the SEC and the Sarbanes-Oxley Act, and is audited quarterly by a public accounting company. We find that the fact petitioner is regulated and audited quarterly is wholly irrelevant to the issue of whether it correctly reported its California sales for sales and use tax. The quarterly audit petitioner relies on is not an audit for purposes of determining if petitioner properly reported sales and use tax. Even if the audit included a determination of petitioner's total sales, and even if that amount were correct, petitioner could have made errors in reporting California sales and use tax which would not have been examined during an audit for other purposes.(e.g,. an error in allocating the sales among the various states, or segregating the taxable and nontaxable sales). In that regard, we note that the information the Department relied on was net of sales that petitioner's records showed as shipped to customers in other states. Such sales delivered from California were required to be reported on line 1 of petitioner's returns, and, if qualifying for exemption, deducted as appropriate. Had petitioner reported correctly, the Department presumably would have tested the claimed exempt interstate sales to ensure that they were claimed properly. However, the Department effectively accepted all such sales as exempt sales without any review since it included no deficiency for sales which were neither reported nor recorded (i.e., netted from both returns and records, such as all sales which reflected out-of-state delivery addresses).

Issue 2: Whether adjustments are warranted to the audited amount of recorded, but not reported, taxable sales. We recommend no adjustment.

The computer file petitioner provided the Department reflected accrued sales tax of $709,936 for the period July 1, 2004, through December 31, 2005. For the same period, petitioner reported sales tax of $671,653, which is $38,283 less than it recorded, for an error rate of 5.7 percent. The Department applied that percentage of error to the amount of sales tax reported for the remainder of the audit period to calculate the additional understatement of reported tax for that period of $18,000, for a total understatement of recorded sales tax of $56,283. Based on this amount, the Department calculated the associated taxable measure that had not been recorded, but not reported, of $649,488.

As discussed under Issue 1, petitioner contends the amount of sales recorded in the computer file includes transactions that were never consummated. Petitioner notes that 8.61 percent and 19.44 percent (the percentages of non-consummated sales petitioner calculated based on responses to XYZ letters) are each greater than the 5.7 percent difference between recorded and reported taxable sales, and asserts this illustrates that this difference represents transactions that were not completed sales.

For the same reasons explained under Issue 1, we do not find the XYZ letters returned with notations that the sales never occurred to be sufficient evidence to support a reduction in audited taxable sales. Petitioner has not provided sales invoices, credit memos, quote sheets, or any similar records to substantiate its contention that some of the recorded tax reimbursement was never actually

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charged and collected. Nor has petitioner provided any other records from which the Department could compile the actual tax reimbursement petitioner collected, *except* for the records provided in the computer file that show petitioner collected sales tax reimbursement of $709,936 for the period July 2004 through December 2005, during which period petitioner reported sales tax of $671,653. Furthermore, the responses to XYZ letters that petitioner seeks to rely on relate to recorded *nontaxable* sales rather than recorded taxable sales. Even if we were to accept that the responses to XYZ letters concerning recorded nontaxable transactions support a finding that some of those recorded nontaxable sales did not occur, it does not automatically follow that the percentages derived from those responses should be used in an analysis of recorded *taxable* sales.

The burden is on petitioner to establish the taxable sales listed in its own records were not actual sales. We find that petitioner has not met that burden, and that no adjustment is warranted.

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

Petitioner did not provide purchase records for use by the Department in verifying the accuracy of petitioner's recorded purchases subject to use tax, so the Department used information from its audit of the period January 1, 2000, through December 31, 2002, to calculate the taxable percentage of petitioner's purchases. During that prior audit period, petitioner reported purchases subject to use tax equal to 6.558 percent of its reported total sales, while, in the audit period at issue, it reported purchases subject to use tax equal to 1.188 percent of its reported total sales. The Department concluded that petitioner's reported purchases subject to use tax were understated. The Department compared the 2.567 percent of reported total sales from the last year of the prior audit to petitioner's reported use tax of 1.188 percent of reported total sales to calculate an understatement equal to 1.379 percent of reported total sales.

Petitioner contends that there was no understatement of reported purchases subject to use tax. Petitioner notes that the Department did not find errors in reported purchases subject to use tax in three prior audits. Petitioner contends that its sales were independent of its purchases, and the use of a percentage of purchases subject to use tax to total sales is not practical. Further, petitioner contends that the audited amount of purchases subject to use tax does not account for the fact that, during the

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audit period at issue, petitioner was preparing to close or sell its business, which resulted in a decrease of purchases.

Petitioner's arguments are logical and seem to support its contention that there was no understatement of use tax. Indeed, the trend of the prior audit (6.558 percent overall, but 2.567 percent in the final year) is relatively consistent with petitioner's use tax reported for the present audit period. That is, petitioner reported purchases subject to use tax equal to 10.66 percent of its reported total sales for 2000, 5.42 percent for 2001, 2.57 percent for 2002, and 1.188 percent in the audit period at issue. However, petitioner has provided no purchase records whatsoever that the Department could use to evaluate the accuracy of reported amounts. Since the D&R does not clearly set forth the difficulty of evaluating this matter, we will provide additional explanation here.

Petitioner was previously audited three times, for the period January 1, 1992, through March 31, 1995, for the period October 1, 1995, through September 30, 1998, and for the period January 1, 2000, through December 31, 2002. Petitioner notes that none of these audits assessed a deficiency for underreported purchases subject to use tax. In the first audit, the Department did not examine petitioner's purchase invoices, but the audit workpapers noted that the auditor had worked with petitioner to develop a method for identifying and recording use tax liability in the future. In the next audit, the Department conducted a spot test and discovered no errors in reported purchases subject to use tax. In the most recent prior audit, the Department reviewed petitioner's purchase invoices for the test period April 1, 2001,through March 31, 2002, and found that purchases subject to use tax had been properly reported.

The audit period at issue here (July 1, 2003, through December 31, 2005) begins about one year after that test period. Thus, the test in the prior audit is sufficiently close in time to the current audit period to be regarded as an indication that petitioner's reported purchases subject to use tax in the current audit period were also reliable. This is particularly true since the Department found no unreported purchases subject to use tax in the three audits which spanned the 11-year period January 1, 1992 through December 31, 2002.

The Department has also acknowledged petitioner's argument that purchases of equipments and supplies are not necessarily dependent on sales in stating that the use of a percentage of purchases

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subject to use tax to total sales is not the most reliable method for establishing audited purchases subject to use tax. However, regarding petitioner's argument that it was preparing to close its business, the Department responds that the audit *does* account for that change in business operations by using the 2.567 percent figure calculated for the last year of the prior audit rather than the 6.558 calculated for the entire three years of the prior audit period.

We find that each of petitioner's arguments is logical. However, we also find that the Department's method for calculating the use tax deficiency is logical and supportable. Petitioner was required to maintain records and present them for audit, but it did not do so, presenting no records *at all* of purchases for this audit period. Petitioner's arguments, although logical, do not establish that it made no mistakes in reporting use tax. We conclude, based on the complete lack of purchase records, that petitioner has failed to provide evidence that the Department's conclusion is incorrect or from which a more accurate determination may be made, and we recommend no adjustment.

OTHER DEVELOPMENTS

None.

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

<u>**Statistical Sample**</u>

Transactions Examined	Nontaxable Sales
Confidence level	80%
Confidence interval	8.128%*
Total number of items in the population	9,559 for stratum 1 2,312 for stratum 2 268 for stratum 3
Number of items randomly selected for the test	500 for stratum 1 300 for stratum 2 268 for stratum 3
Number of errors found	8 for stratum 1 8 for stratum 2 26 for stratum 3)
Whether stratification was used, and if so what was stratified	Stratified by sales amount $100 - $1000 $1000.01-$10,000 Greater than $10,000
Average dollar value of population	$383 for stratum 1 $2,532 for stratum 2 $32,522 for stratum 3
Dollar value of remaining errors	$1,942 for stratum 1 $12,316 for stratum 2 $603,775 for stratum 3
Dollar value of sample	$191,096 for stratum 1 $783,721 for stratum 2 $8,715,818 for stratum 3
Percentage of error	1.02% for stratum 1 1.57% for stratum 2 Actual basis for stratum 3
Were XYZ letters sent	yes
Number of XYZ letters sent	57
Percentage of XYZ letters sent in relation to number of tested items	7%**
Number of responses to XYZ letters received	46**
Percentage of responses to XYZ letters received in relation to the number of XYZ letters sent	81%
Number of responses to XYZ letters received accepted as proof of valid nontaxable sales	38
Percentage of responses to XYZ letters received accepted as proof of valid nontaxable sales	83%
Number of responses to XYZ letters treated as taxable	8
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 were more than one invoice to the same customer. Accordingly, the percentage of 7% is an estimate. This may also be the reason that we count 46 responses to XYZ letters while petitioner states there were 36 responses.

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