CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION BOARD HEARING SUMMARY

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of: PCS WIRELESS, INC. dba Premiere Mobile Petitioner	Account Number SR EA 101-019673 Case ID 572015 Garden Grove, Orange County

Type of Business: Cell phone retailer

Liability period: 01/01/08 - 12/31/10

Item	Disputed Amount
Unreported taxable sales	$1,522,284
Negligence penalty	$ 12,615

Tax, as determined and protested	$126,147.86
Interest through 02/29/16	53,304.68
Negligence penalty	12,614.80
Total tax, interest, and penalty	$192,067.34
Monthly interest beginning 03/01/16	$ 630.74

The Board held a hearing regarding this matter on June 24, 2015, and it voted to continue the hearing to a later day. The Board granted petitioner 30 days to provide additional evidence and the Sales and Use Tax Department (Department) 30 days to review petitioner's submission and respond. The Appeals Division has reviewed the post-hearing materials, and has concluded that no adjustments are warranted, as more fully explained under "Other Matters."

UNRESOLVED ISSUES

Issue 1: Whether any adjustments to the amount of unreported taxable sales are warranted. We find that no adjustments are warranted.

Petitioner sold cellular phones and accessories as an authorized representative of T-Mobile Wireless during the period January 2008 through January 2011. The Board's Statewide Compliance Outreach Program (SCOP) found that the gross receipts reported on petitioner's 2008 federal income tax return exceeded the total sales reported on its sales and use tax returns, and concluded that petitioner had underreported its sales. SCOP advised petitioner to review its records and to amend its sales and use tax returns. SCOP referred the case to the Department because SCOP found that the taxable sales on the (proposed) amended returns were lower than expected for this type of business. Petitioner provided its bank statements for 2008 and 2009, but provided no other records for audit.

Based on audits of similar businesses, the Department estimated that 69.49 percent of petitioner's gross receipts represent taxable sales of cellular phones and accessories. The Department applied the taxable sales ratio to gross receipts reported on petitioner's 2008 federal income tax return to establish audited taxable sales of $615,787, which exceeded reported taxable sales of $68,780 by $547,007 for 2008. The Department used the error rate of 795.30 percent ($547,007 ÷ $68,780) to compute unreported taxable sales of $581,061 for 2009. Because reported taxable sales for 2010 were significantly higher than in 2008 and 2009, the Department established audited taxable sales for 2010 by averaging audited taxable sales for 2008 and 2009. In total, the Department established unreported taxable sales of $1,522,284 for the audit period.

Petitioner contends that audited taxable sales are overstated because the gross receipts reported on its 2008 federal income tax returns are overstated. Petitioner asserts that audited gross receipts should be established using the bank statements provided. The Department concluded that the bank statements provided exclude sales paid for with credit cards, and that there is evidence that some of petitioner's purchases might have been paid for with cash that was never deposited. Moreover, the Department's examination of the bank statements showed that petitioner transferred money to another bank account, and petitioner failed to provide the bank statements for the other account. We find that the bank statements provided cannot be relied upon to establish petitioner's gross receipts. Further, petitioner has provided no evidence to support its contention that the gross receipts reported on its 2008 federal income return are overstated. We also note that audited taxable sales of $615,787 for 2008 are substantially less than petitioner's cost of merchandise sold of $758,146 for 2008. We would not expect petitioner's sales to be less than its cost of merchandise sold, and we find that the Department's computation of audited taxable sales was conservative. We thus conclude that no adjustments are warranted.

We note that petitioner had provided additional documents shortly before a hearing that was scheduled in October 2014. During the Department's review of those documents, petitioner provided bank statements for two bank accounts for most months of the audit period; the recorded purchases of cell phones and accessories for 2008 and 2010; federal income tax returns (FITR's) for 2008, 2009, and 2010; and service agreements for the months of August, September, and October 2008.

The FITR's petitioner provided were not the FITR's that had been filed with the Franchise Tax Board. Although petitioner states that the FITR's had been amended, there is no evidence that the amended returns were filed. Accordingly, the Department concluded that the new FITR's provided were not a reliable source of information regarding petitioner's sales. Regarding the bank statements, the Department noted that there are two additional bank accounts for which petitioner has not provided complete bank statements.

With regard to the markup, the Department noted that there is insufficient information to compute a markup on the cost of cell phones because petitioner has not provided sales invoices for sales of cell phones in unbundled transactions. Accordingly, the Department concluded that a markup audit was not feasible. However, the Department has applied an 18 percent markup[1] to the purchase of cell phones on the 2008 FITR and has computed sales for that year of $894,612. Since reported sales for 2008 were $68,780, the difference of $825,832 computed using an estimated 18 percent markup would result in an error ratio of over 1200 percent, far greater than the audited percentage of error of about 400 percent for the audit period.

In summary, based on its review of all documentation presented by petitioner prior to the June 24, 2015 hearing, the Department concluded that the information presented did not support any adjustment, and we concurred.

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

The Department imposed the negligence penalty because petitioner did not maintain adequate books and records, and the understatement is large in relation to the reported measure of tax. Petitioner disputes the negligence penalty, but has not provided any specific contentions.

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[1] The Department used an estimated markup of 18 percent since that markup is referred to in California Code of Regulations, title 18, section 1585, as an acceptable markup for cell phones sold in bundled transactions if there is no other evidence from which a more accurate markup can be computed.

A comparison of the understatement of $1,522,284 with reported taxable sales of $382,583 shows an error rate of 397.89 percent,[2] which we find is strong evidence of negligence in reporting. We also find that petitioner's failure to maintain and provide complete sets of sales and purchase records is evidence of negligence in keeping records. We find that petitioner's failure to report nearly 80 percent of its taxable sales ($1,522,284 ÷ ($1,522,284 + $382,583) = 79.9 percent), its failure to provide standard accounting records for audit, and the broad discrepancies between amounts reported for income tax purposes and for sales and use tax purposes cannot be attributed to petitioner's bona fide and reasonable belief that its bookkeeping and reporting practices were sufficiently compliant with the requirements of the Sales and Use Tax Law. Under such circumstances, the imposition of a negligence penalty in a first-time audit is appropriate. (*Cf. Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 321-324.)

OTHER MATTERS

At the Board hearing on June 24, 2015, petitioner's representative stated he could provide bank statements for all four of petitioner's business bank accounts and for the corporate president's personal bank account, as well as a general ledger for 2010. As noted previously, the Board granted petitioner 30 days to provide additional documentation and the Department 30 days to respond. The Members also requested that the Department provide petitioner as much consultation as possible, and that it explain the Officer In Compromise (OIC) and Settlement programs to petitioner.

After the hearing, petitioner provided bank statements for two of the corporate president's personal bank accounts and a general ledger for 2010. Petitioner's representative told the Department that the 2010 general ledger had been prepared after the Board hearing from bank statements. The Department noted that the revenue posted to the general ledger, described as "cash receipts," does not reconcile to the known bank deposits and does not appear to include the bank deposits for the first quarter 2010. Petitioner has not explained the discrepancies between the known bank deposits and the amount of revenue recorded in the general ledger. In addition, there is evidence that petitioner may

[2] The overall error ratio of 397.89 percent for the audit period is substantially lower than the error ratio of 795.30 percent established using information from 2008 because the Department found petitioner reported more taxable sales in 2010 than in prior years.

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have made purchases with cash, and the records are not sufficiently complete to determine whether that cash was deposited in the bank. In addition, while petitioner agreed to provide the bank statements for the two additional bank accounts and documentation to show that the FITR for 2008 was not accurate, that evidence was not included in the post-hearing submissions. We find that petitioner has not provided the evidence discussed at the Board hearing and that the incomplete bank statements and the general ledger completed from those bank statements are not sufficient to warrant adjustments. Accordingly, our recommendation remains to make no adjustments to the determined liability.

The Department explained the Settlement and OIC programs to petitioner's representative, and it asked the Settlement Division to contact the representative to provide assistance. The representative indicated that petitioner could not qualify for the OIC program because the corporate officers have the ability to pay the liability.

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