CALIFORNIA STATE BOARD OF EQUALIZATION

SUMMARY DECISION UNDER REVENUE AND TAXATION CODE SECTION 40

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of:		
	Account Number	SR Y FH 97-205730
MOBILE TELESYS, INC.	Case ID	486216
	Oral hearing date:	March 12, 2013
Petitioner		

Representing the Parties:

For Petitioner:	Appearance waived
For Sales and Use Tax Department:	Erin Dendorfer, Tax Counsel
For Appeals Division:	Jeffrey G. Angeja, Tax Counsel IV

LEGAL ISSUE 1

Whether adjustments are warranted to the amount of unreported taxable sales.

FINDINGS OF FACT AND RELATED CONTENTIONS

Petitioner sold cellular telephones, related accessories, and Verizon Wireless (Verizon) service contracts from January 1998 through June 2003. Petitioner consistently reported its total sales as taxable sales. Petitioner used a computerized point-of-sale accounting system that tracked and recorded sales data; however, petitioner only provided limited records for audit, consisting of copies of sales and use tax returns, summaries or worksheets from various locations, and a copy of petitioner's 2003 federal income tax return. These records showed that petitioner collected sales tax reimbursement, measured by the retail selling price of tangible personal property sold. The Sales and Use Tax Department (Department) found that gross receipts of $10,901,011 reported on petitioner's 2003 federal tax return exceeded total sales reported on petitioner's sales and use tax returns for 2003 of $1,918,191 by $8,982,820. In light of that significant discrepancy, the Department decided to establish audited taxable sales on a markup basis, and it used 2003 as a test period. The Department used purchases of $2,767,475 (shown on the federal tax return) as the audited cost of goods sold, and it estimated that 90 percent of the merchandise sold represented phones, while the remaining 10 percent represented accessories. The Department reduced the costs in both categories by pilferage losses, estimated at 2 percent. It then added an 18 percent markup to compute audited sales of phones and a 100 percent markup to compute audited sales of accessories. The Department compared audited sales of phones and accessories to reported taxable sales for 2003 and computed an understatement of 78.43 percent, which it applied to reported taxable sales for the audit period.

Petitioner contends it was not in the business of selling telephones and accessories, but was in the business of selling Verizon's cellular service contracts. Petitioner states that it gave telephones and accessories away as an incentive for the customer to purchase a minimum two-year cellular service contract, and that the few telephone sales it made were to customers who wanted more than the basic "free" phone. Petitioner thus asserts that the maximum measure of tax should be its cost, arguing that it provided telephones and accessories to its customers in exchange for less than 50 percent of its cost for the equipment, and it states that the cost of phones and accessories has already been reported on its returns. Petitioner also claims that the difference between gross receipts reported on its FITR and taxable sales reported on its sales and use tax returns is due to commissions paid by Verizon and does not represent gross receipts from the sale of tangible personal property. Petitioner further states that it experienced extensive losses from theft and obsolescence.

APPLICABLE LAW

California imposes sales tax on all retail sales of tangible personal property in this state, unless the sale is exempt or excluded from tax. (Rev. & Tax. Code, § 6051.) Taxable gross receipts include all amounts received with respect to the sale, with no deduction for the cost of materials, service, or expense of the retailer passed on to the purchaser, unless there is a specific statutory exclusion. (Rev. & Tax. Code, § 6012, subd. (a).) If the Board is not satisfied with the tax returns of a taxpayer, it may compute and determine the amount of tax required to be paid upon the basis of any information within its possession or that may come into its possession. (Rev. & Tax. Code, § 6481.)

California Code of Regulations, title 18, section (Regulation) 1585 is expressly applicable to sales of wireless telecommunication devices, such as cellular telephones, that require activation of service through a wireless telecommunication service provider. It sets out specific rules for the tax treatment of bundled and unbundled sales of such devices.[1] As relevant herein, Regulation 1585 states that tax applies to the gross receipts from the retail sale of a wireless telecommunication device sold in a bundled transaction measured by the "unbundled sales price"[2] of that device, regardless of whether the device and utility service are sold for a single price or are separately itemized in the context of a sale or on a sales invoice, and the retailer is allowed to collect sales tax reimbursement measured by that unbundled price. (Cal. Code Regs., tit. 18, § 1585, subd. (b)(3).) If the retailer cannot establish an unbundled sales price to the satisfaction of the Board based upon its own sales records, the unbundled sales price of the device shall equal the fair retail selling price of that device. (Cal. Code Regs., tit. 18, § 1585, subd. (a)(4).) If tax is reported and paid on an amount equal to the cost of the device plus a markup on cost of at least 18 percent, such amount shall be regarded as the fair retail selling price of the device. (*Id.*) If the retailer sells a wireless device at a price, measured by the actual sales price in an unbundled transaction or the unbundled sales price, for less than 50 percent of cost, then the retailer must report and pay use tax measured by the cost to it of the device. (Cal. Code Regs., tit. 18, § 1585, subd. (b)(6).)

ANALYSIS & DISPOSITION

Petitioner has provided no evidence to show that it gave telephones away and reported the cost of telephones on its returns. In that regard, the amount of $1,918,191 reported on petitioner's sales and use tax returns for 2003 was much less than its cost of merchandise of $2,767,475, which contradicts its assertion that it was reporting the cost of equipment as the taxable amount. Also, these figures do not support a conclusion that the phones were sold for less than 50 percent of the cost because reported sales for 2003 are less than the recorded costs by only about 31 percent. Thus, we find the evidence does not support petitioner's assertion that the measure of tax should be its cost of the phones and accessories. Instead, the evidence establishes that petitioner sold phones with required, two-year

[1] A bundled transaction is the retail sale of a wireless communication device which contractually requires the retailer's customer to activate or contract with a wireless telecommunications service provider for utility service for a period greater than one month as a condition of that sale.

[2] The unbundled sales price is the price at which the retailer has sold specific wireless telecommunication devices to customers who are not required, as a condition of the sale, to activate or contract for wireless service, whether with the retailer or an independent wireless telecommunications service provider. (Cal. Code Regs., tit. 18, § 1585, subd. (a)(4).)

Verizon service contracts. Therefore, we conclude that petitioner made retail sales of phones in bundled transactions.

Petitioner did not provide records from which the Department could compute a markup, and, in any event, there was no evidence that petitioner had made any unbundled sales from which the retail selling prices of telephones could be determined. Accordingly, it was appropriate for the Department to use a markup of 18 percent for sales of phones. (Cal. Code Regs., § 1585, subd. (a)(4).) Also, we find the estimated markup of 100 percent was reasonable for sales of accessories. Petitioner has offered no persuasive evidence to show that the audited markups are excessive.

Regarding petitioner's claim that the difference between gross receipts reported on its federal tax return and total sales reported on the sales and use tax returns for 2003 represents commissions paid by Verizon, petitioner has provided no evidence. In any event, the nature of that difference is not relevant to this analysis since the Department did not use that difference to establish audited sales. Petitioner also has not offered evidence to support its assertion that there were extensive losses due to theft and obsolescence. The Department has already allowed losses due to pilferage of 2 percent, which is greater than the standard 1-percent allowance, and petitioner has not provided documentation of additional losses. In summary, we find that petitioner has not identified errors in the audit procedures or computations, and it has not provided records from which a more accurate amount of sales could be established. Accordingly, we find no adjustment is warranted. (See Rev. & Tax. Code, § 6481.)

LEGAL ISSUE 2

Whether an adjustment is warranted for bad debts.

FINDINGS OF FACT AND RELATED CONTENTIONS

Although petitioner has not specifically claimed that it is entitled to deduct bad debts from the taxable measure, and has provided no evidence in support of such a deduction, the available information suggests this as a possible argument. A July 5, 2007 email from petitioner's former lawyer to its current representative states that petitioner returned telephones to Verizon without receiving credit and that Verizon wrongly deducted charge-backs from "commissions" owed to petitioner. Either argument potentially represents a bad debt owed by Verizon for the price of telephones included in the measure. We have analyzed them as such.

APPLICABLE LAW

A retailer is relieved from liability for sales tax when the measure of the tax is represented by accounts that have been found to be worthless and charged off for income tax purposes by the retailer or, if the retailer is not required to file income tax returns, charged off in accordance with generally accepted accounting principles. (Rev. & Tax. Code, § 6055, subd. (a).) The deduction for the bad debt should generally be taken on the return filed for the period during which the bad debt was written off for income tax purposes or, if the taxpayer was not required to file an income tax return, the period during which the bad debt was written off according to generally accepted accounting principles. (Cal. Code Regs. tit. 18, § 1642, subd. (a).) Retailers are required to maintain adequate records to support a claim of a bad debt deduction or refund, including records that show details of the sale and the purchaser's account and evidence that the account had been written off as prescribed. (Cal. Code Regs. tit. 18, § 1642, subd. (e).)

ANALYSIS & DISPOSITION

Petitioner has provided no evidence to establish an entitlement to a bad debt deduction, and we therefore find no adjustment is warranted.

LEGAL ISSUE 3

Whether petitioner was negligent.

FINDINGS OF FACT AND RELATED CONTENTIONS

The Department imposed a 10-percent negligence penalty on the ground that that petitioner did not provide adequate records. Petitioner had a computerized point-of-sale accounting system in its various locations. It reported over $18.8 million in taxable sales for 1999, over $31.7 million in taxable sales for 2000, and over $17.3 million in taxable sales for 2001, yet the business records it provided for this audit consisted only of copies of sales and use tax returns and worksheets and a copy of petitioner's 2003 federal income tax return. In addition, the under-reported measure of tax exceeds $5 million, and the percentage of error is over 78 percent.

Petitioner denies that it was negligent, and asserts that there was such a climate of despair and animosity toward Verizon in the final weeks of its business operations that records were either not created or were lost. This was petitioner's first audit.

APPLICABLE LAW

Revenue and Taxation Code section 6484 provides for the imposition of a 10-percent penalty if any part of the deficiency for which a deficiency determination is made was due to negligence or intentional disregard of the law or authorized rules and regulations. Negligence is the failure to act with due care and to do what a reasonably prudent person would do under the same or similar circumstances. (See Sales and Use Tax Audit Manual § 0506.10.) The failure to maintain and keep complete and accurate records will be considered evidence of negligence. (Cal. Code Regs., tit. 18, § 1698, subd. (k).)

ANALYSIS & DISPOSITION

Petitioner had a computerized point-of-sale accounting system in its various locations, yet failed to provide adequate records for the audit. The explanation that there was such a climate of despair and animosity toward Verizon in the final weeks that records were either not created or were lost, is inadequate. The obligation to create and maintain adequate business records for tax reporting does not depend on the relationship between a business and its customers or affiliates. The explanation also does not address the business records that should have been available for the years before those final weeks when the relationship between petitioner and Verizon allegedly soured. In addition, we find that the percentage of error of 78.43 percent is further evidence of negligence. We find that petitioner was negligent and that penalty was properly applied.

LEGAL ISSUE 4

Whether relief from the amnesty penalties is appropriate.

FINDINGS OF FACT AND RELATED CONTENTIONS

A portion of petitioner's tax liability, April 1, 2002, through December 31, 2002, accrued within the amnesty-eligible period. (Rev. & Tax. Code, § 7071.) Petitioner did not participate in the amnesty program, and therefore an amnesty double negligence penalty of $32,989.66 has been added to the determination (see Rev. & Tax. Code, § 7073, subd. (c)), and an amnesty interest penalty of $31,961.07 will be added when the liability becomes final (see Rev. & Tax. Code, § 7074, subd. (a)).

During the appeals process, staff advised petitioner of the requirement for a statement signed under penalty of perjury requesting relief from these penalties (see Rev. & Tax. Code, § 6592, subd. (a)). Petitioner's representative stated that petitioner has gone out of business, and he is unable to contact anyone from whom he can obtain a request for relief of the amnesty penalties. Therefore he has declined to file such a request.

APPLICABLE LAW

Revenue and Taxation Code section 6592, subdivision (a) provides that an amnesty interest penalty and amnesty doubling penalties may be relieved if the Board finds that a person's failure to apply for amnesty or timely pay the tax and interest due for amnesty-eligible periods was due to reasonable cause and circumstances beyond the person's control and occurred notwithstanding the exercise of ordinary care and in the absence of willful neglect. A person seeking relief must submit a statement under penalty of perjury setting forth the facts on which it bases the claim for relief. (Rev. & Tax. Code, § 6592, subd. (b).)

ANALYSIS & DISPOSITION

Petitioner has not submitted a statement under penalty of perjury setting forth facts on which it might base a claim for relief from the amnesty penalties. Accordingly, we have no basis on which to grant relief.

ORDER

It is hereby ordered that the petition be denied and that the matter be redetermined without adjustment.

Adopted at Culver City, California, on July 17, 2013.

Jerome E. Horton, Chairman

Michelle Steel, Member

Betty T. Yee, Member

George Runner, Member

Marcy Jo Mandel, Member*

*For John Chiang, pursuant to Government Code section 7.9.