OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **EMA DESIGN AUTOMATION, INC.**	) OTA Case No. 18114022) CDTFA Case ID: 872315) CDTFA Account No. 100-155781)))

OPINION

Representing the Parties:

For Appellant: Paul W. Raymond, Attorney

For Respondent: Kevin Smith, Tax Counsel III
                                        Monica Silva, Tax Counsel IV
                                        Lisa Renati, Hearing Representative

J. ANGEJA, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, appellant EMA Design Automation, Inc. (appellant) appeals an action by the California Department of Tax and Fee Administration (CDTFA) denying appellant's timely petition for redetermination of an April 16, 2015 Notice of Determination (NOD). The NOD is for $220,733.02 in tax, plus applicable interest.

Office of Tax Appeals Administrative Law Judges Andrew J. Kwee, Michael F. Geary, and Jeffrey G. Angeja held an oral hearing for this matter in Cerritos, California, on December 19, 2019. At the conclusion of the hearing, the record was closed and this matter was submitted for decision.

ISSUE

Whether appellant established that it is entitled to relief from the tax and interest based on written advice provided in a prior audit.

FACTUAL FINDINGS

The Current Audit Liability

1. Appellant, a retailer of product development solutions software, is located in Rochester, New York. Appellant holds a Certificate of Registration – Use Tax.[1]

2. CDTFA audited appellant for the period January 1, 2011, through December 31, 2013. In this audit, CDTFA examined on an actual basis and block test basis appellant's claimed exempt and nontaxable sales.[2] CDTFA found that appellant improperly claimed software transactions involving the transfer of a required dongle as nontaxable sales.[3]

3. On April 16, 2015, CDTFA issued an NOD to appellant for tax of $220,733.02, plus applicable interest.

4. Appellant filed a timely petition for redetermination, protesting the NOD on the basis that CDTFA accepted these transactions in a prior audit.

5. In a Decision issued October 22, 2018, CDTFA denied appellant's request to relieve the tax and interest.

6. This timely appeal follows.

The Prior Audit of Appellant

7. CDTFA conducted a prior audit of appellant for the period April 1, 2003, through March 31, 2006. The prior audit workpapers show that CDTFA reviewed three invoices that listed dongles as part of the transaction, but CDTFA treated these transactions as being nontaxable. The audit workpapers also show that CDTFA reviewed 14 other invoices that listed dongles as part of the transaction, and CDTFA found these transactions to be taxable.

8. In relevant part, the Verification Comments (Schedule 12-1, page 1) of the prior audit workpapers state the "[a]uditor examined the data furnished…. On the exempt

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[1] A Certificate of Registration – Use Tax requires businesses to collect California use tax, and it is issued to businesses that are engaged in business under R&TC section 6203 and that sell or lease tangible personal property to California purchasers. (Cal. Code Regs., tit. 18, § 1684.)

[2] Appellant claimed nontaxable sales for resale, sales of electronically downloaded software, and exempt sales to the United States Government.

[3] A dongle is a security device containing code that prevents unauthorized use of the software. Appellant's software was designed to be effectively nonfunctional without the dongle.

Internet transactions, the data show that all items were transmitted through the internet with no tangible personal property involved. Thus, these are allowed in the audit."

9.   The prior audit was completed on December 5, 2006. On that same date, at 5:54 p.m., appellant sent an email to CDTFA requesting written guidance as to the proper application of tax to the transactions involving the transfer of dongles. In response, CDTFA declined to provide guidance to appellant because of the pendency of the audit, and CDTFA directed appellant to refer its inquiries directly to the auditor.

<u>DISCUSSION</u>

California imposes sales tax on a retailer's retail sales in this state of tangible personal property, measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, § 6051.) When sales tax does not apply, use tax applies to the storage, use, or other consumption of tangible personal property purchased from any retailer for storage, use, or other consumption in this state, measured by the sales price, unless that use is specifically exempted or excluded by statute. (R&TC, §§ 6201, 6401.) A retailer engaged in business in this state and making sales of tangible personal property for storage, use, or other consumption in this state shall collect the tax from the purchaser. (R&TC, § 6203.)

The sale or lease of a prewritten program is not a taxable transaction if the program is transferred by remote telecommunications from the seller's place of business, to or through the purchaser's computer, and the purchaser does not obtain possession of any tangible personal property, such as a storage media, in the transaction. (Cal. Code Regs., tit. 18, § 1502(f)(1)(D).)

R&TC section 6596(a), provides that if a person's failure to make a timely return or payment was due to that person's reasonable reliance on written advice from CDTFA, the person may be relieved of any sales or use taxes imposed. A taxpayer is eligible for relief if, in reasonable reliance on the written advice, the taxpayer failed to charge or collect sales tax reimbursement or use tax from its customer. (R&TC, § 6596(b)(3).) A person seeking relief is required to file a statement signed under penalty of perjury setting forth the facts on which the claim for relief is based, as appellant has done in this appeal. (See R&TC, § 6596(c)(2).)

If a previous audit of the person requesting relief contains written evidence demonstrating that the issue in question was examined, either in a sample or census (actual) review, such evidence will be considered written advice from CDTFA. (Cal. Code Regs., tit. 18, § 1705(c).)

Audit comments, schedules, and other writings prepared by CDTFA that become part of the audit work papers which reflect that the activity or transaction in question was properly reported, and no tax amount was due, are sufficient for a finding for relief from liability, unless it can be shown that the person seeking relief knew such advice was erroneous. (*Ibid.*) As relevant, the presentation of a person's books and records for examination by an auditor is deemed to be a written request for the audit report by the audited person. (Cal. Code Regs., tit. 18, § 1702(c).)

A charge for software that includes the transfer of a required dongle is taxable without regard to the manner the software is transferred because the customer must also obtain an important piece of tangible personal property that is required to make the software functional. (See R&TC, § 1502(f)(1)(D).) Here, appellant does not dispute the taxability of these transactions; however, appellant argues that because CDTFA treated three transactions involving dongles as nontaxable in the prior audit, relief of the tax and interest at issue here is warranted under R&TC section 6596. Additionally, appellant argues that CDTFA orally advised appellant in the prior audit that transactions involving the shipment of dongles are nontaxable.

It is undisputed that in the prior audit, CDTFA improperly accepted as nontaxable three transactions involving the transfer of dongles; however, it is also undisputed that in the prior audit CDTFA treated 14 similar transactions as taxable. In addition, the Verification Comments from the prior audit indicated that such transactions were taxable. Apparently based on the conflicting advice, appellant emailed an inquiry to CDTFA regarding the proper application of tax, but appellant was directed to contact the auditor. There is no evidence of any written response from the auditor.[4]

A taxpayer's reliance on written advice must be objectively reasonable. (R&TC, § 6596(a), (b)(3); Cal. Code Regs., tit. 18, § 1705(a).) Here, despite the conflicting written advice regarding the taxability of the disputed transactions, appellant changed its reporting practices and ceased charging or remitting tax on transactions involving the transfer of a dongle. In light of the 14 transactions that were properly taxed in the prior audit, and the Verification Comments indicating the proper application of tax, we find that it was not reasonable for appellant to rely on the comparatively small number of errors (3) in the prior audit. We

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[4] The parties dispute the content of the oral advice the auditor may have provided to appellant, but we need not determine what oral advice the auditor may have provided to appellant, because oral communications do not constitute a basis for relief. (R&TC, § 6596(a); Cal. Code Regs., tit. 18, § 1705(a); *Appeal of Salam & Perveen*, 2019-OTA-041P.)

understand that appellant may have been satisfied with the alleged oral advice it received, but oral advice is insufficient to protect appellant (see footnote 4). Further, we believe that a reasonably prudent businessperson would have again sought written advice from CDTFA once the prior audit was concluded, or sought written clarification from the auditor, which appellant failed to do.

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HOLDING

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Appellant failed to establish a valid basis for relief of the tax and interest.
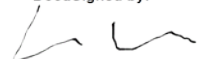
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DISPOSITION

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CDTFA's action is sustained.

DocuSigned by:

Jeff Angeja

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Jeffrey G. Angeja
Administrative Law Judge

We concur:

DocuSigned by:

Michael F. Geary

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Michael F. Geary
Administrative Law Judge

DocuSigned by:

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Andrew J. Kwee
Administrative Law Judge

Date Issued: 3/4/2020