

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:
IMAGE 2000

)
) OTA Case No. 18012322
) CDTFA Account No. 99-427900
) CDTFA Case ID 995623
)
)

OPINION

Representing the Parties:

For Appellant:

Mardiros H. Dakessian, Attorney
Lucian Khan, Attorney
Ruben Sislyan, Attorney

For Respondent:

Jarrett Noble, Attorney
Scott Claremon, Attorney
Lisa Renati, Hearing Representative

For Office of Tax Appeals:

Lisa Burke, Business Taxes Specialist III

A. KWEE, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Image 2000 (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)¹ denying appellant’s timely petition of a Notice of Determination (NOD) dated January 20, 2017. The NOD is for \$435,801.46 in tax, plus applicable interest, for the period January 1, 2012, through December 31, 2014 (audit period). This matter is being decided based on the written record because appellant waived the right to an oral hearing.²

¹ Sales taxes were formerly administered by the Board of Equalization (board). Effective July 1, 2017, functions of the board relevant to this case were transferred to CDTFA. (Gov. Code, § 15570.22.) When referring to acts or events that occurred before July 1, 2017, CDTFA shall refer to its predecessor, the board.

² On November 26, 2019, during a pre-hearing conference, the parties agreed that there is no dispute for the Office of Tax Appeals (OTA) to decide with respect to the calculation of the liability or application of tax to the charges, and that the sole issue for OTA to decide is whether relief is applicable under R&TC section 6596 based on appellant’s reliance on written advice provided in a prior audit.

ISSUE

Whether appellant established a basis for relief of its 2012 through 2014 sales and use tax liability pursuant to R&TC section 6596.

FACTUAL FINDINGS

1. Appellant is a retailer of office printers and copiers (printing equipment). Appellant also sells optional maintenance contracts for its printing equipment.
2. Appellant's optional maintenance contracts are typically billed on a monthly, quarterly, or yearly basis. Pursuant to the optional maintenance contracts, appellant provides its customers with repair or replacement parts required to maintain the printing equipment. Appellant also provides consumable supplies (ink and toner). Depending on the terms of the agreement between appellant and the customer, appellant may also include a separately stated charge for the ink and toner. Appellant calculates the charge for ink and toner based on how much the customer used the printer (i.e., a per-page charge).
3. Appellant collected and remitted sales tax to CDTFA on 10 percent of its total charges for optional maintenance contracts, and 10 percent of its separately stated per-page charges for ink and toner. Appellant purchased all of these items without payment of tax to its supplier or to CDTFA.
4. On or about January 7, 2015, CDTFA notified appellant that it had been selected for an audit. Appellant's cost of repair and replacement parts, and of ink and toner, exceeded the 10 percent of the total charge amount that appellant collected tax on from its customers and reported as taxable to CDTFA. Specifically, for the audit period, appellant's cost of repair and replacement parts furnished under the optional maintenance contracts exceeded the taxable measure appellant reported on its optional maintenance contracts by \$2,252,988. Additionally, appellant's cost of ink and toner furnished in connection with the per-page charges exceeded the taxable measure appellant reported on its per-page charges by \$2,663,396.
5. As relevant to this appeal, CDTFA determined that appellant failed to properly report or pay tax on: (1) repair and replacement parts furnished under the optional maintenance

- contracts, and (2) ink and toner furnished in connection with the separately stated per-page charges.
6. During the audit, CDTFA advised appellant that, pursuant to California Code of Regulations, title 18, section (Regulation) 1546(b)(3)(C), appellant was the consumer of repair and replacement parts furnished under the optional maintenance contracts and owed tax on its cost for these items. CDTFA also advised appellant that the separately stated per-page charge for ink and toner was taxable as a retail sale of ink and toner (appellant had been reporting tax on 10 percent of the per-page charge).
 7. Based on its review of the prior audits, CDTFA determined that it erroneously advised appellant that it was the consumer of ink and toner and CDTFA granted partial relief of the taxes under R&TC section 6596. Based on the partial tax relief, CDTFA only billed appellant for taxes measured by appellant's cost of ink and toner during the current audit period (i.e., CDTFA excluded any markup over cost from the taxable measure).

The prior audit for the period April 1, 1994, though March 31, 1997 (the first prior audit)

8. At CDTFA's initial appointment with appellant to examine its records for the first prior audit, appellant advised the auditor that no formal books and records existed, and that the sales and use tax returns for the audit period had been filed based on estimates made by one of appellant's corporate officers. CDTFA issued a subpoena to obtain appellant's books and records; however, appellant provided no additional records, claiming that they did not exist. Thereafter, CDTFA obtained appellant's bank statements and computed the audited taxable measure based on an analysis of bank deposits.
9. In the first prior audit, CDTFA determined that appellant failed to report tax on its cost of replacement parts that it consumed. Based on the available information, CDTFA estimated appellant's cost of such parts was approximately 10 percent of the amount of appellant's total service billings in the prior audit, and billed appellant for this amount.

The prior audit for the period April 1, 1998, through March 31, 2001 (the second prior audit)

10. For the second prior audit, appellant's books and records were comprehensive and consistent. Appellant added sales tax reimbursement to 10 percent of its total charges for

optional maintenance contracts. CDTFA examined appellant's reported sales using a block sample for the first quarter of 2000 (1Q00).

11. Regarding the optional maintenance contracts, audit verification comments state that “part and supply items on maintenance contracts representing 10% of the contract amount were taxed on invoices. No discrepancies noted during spot test of 1Q00.”
12. Similarly, audit comments under a schedule titled “Labor Analysis year 2000” state: “The labor percentage of 90% for the Contract Invoices Journal was confirmed by examination of sales invoices for 1Q-00. All contract invoices showed tax billed on 10% of billing. Therefore, the labor portion was 90%.”
13. General Audit Comments dated February 4, 2004, summarize the findings as follows: “The maintenance agreements are optional and taxpayer has elected to report & bill tax on 10% of contract billing that represents parts and supplies used for maintenance contracts. No detailed examination of costs was conducted. This percentage was determined in the prior audit. Auditor requested a sample maintenance contract with list of supplies and parts along with prices to verify percent is still 10%.”

The prior audit for the period July 1, 2004, through June 30, 2007 (the third prior audit)

14. For the third prior audit, CDTFA used statistical sampling to verify the accuracy of appellant's reported amounts. As in the second prior audit period, appellant charged sales tax reimbursement on exactly 10 percent of its selling price for optional maintenance contracts (in other words, appellant treated the transaction as 10 percent taxable, and 90 percent nontaxable). The parts and supplies used for the optional maintenance contracts were not itemized in appellant's detailed journals. In addition to reconciling the sales tax reimbursement collected with reported tax, CDTFA tested the source documents related to one sample optional maintenance contract.
15. The Audit Verification Comments were nearly identical to the comments in the prior audit, and state, “The maintenance agreements are optional and taxpayer has elected to report and bill tax on 10% of contract billing that represents parts and supplies used for maintenance contracts. No detailed examination of costs was conducted. This

percentage was determined in the prior audit. Auditor requested a sample maintenance contract with list of supplies and parts along with prices to verify percent is still 10%.”

DISCUSSION

The law provides that if a taxpayer’s failure to timely pay the tax is due to reasonable reliance on written advice provided by CDTFA (or, prior to July 1, 2017, the board), the taxpayer may be relieved on the taxes, interest, and any penalties added thereto. (R&TC, §§ 20, 6596(a).) OTA has statutory authority to decide an appeal involving a request for relief of taxes, interest and penalties pursuant to R&TC section 6596. (Gov. Code, § 15671(a)(6).) R&TC section 6596 imposes four general requirements in order to grant relief, which are summarized, in pertinent part, as follows: First, the taxpayer must request written advice on the application of tax from CDTFA and the request must set forth the specific facts and circumstances of the activity or transactions for which the advice is requested. (R&TC, § 6596(b)(1).) Second, CDTFA must respond in writing, stating whether or not the described activity or transaction is subject to tax, or stating the conditions under which the activity or transaction is subject to tax. (R&TC, § 6596(b)(2).) Third, the taxpayer must reasonably rely on the written advice. (R&TC, § 6596(b)(3).) Fourth, the liability for taxes must occur before CDTFA rescinds the advice or a change in law renders the advice no longer valid. (R&TC, § 6596(b)(4).) Any person requesting relief of the taxes must file a statement under penalty of perjury setting forth the facts on which a request for relief of the taxes is based. (R&TC, § 6596(c).)

In the instant case, the claim for relief under R&TC section 6596 is based upon written advice provided in a prior audit. 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 for purposes of the first requirement (requesting written advice). (Cal. Code Regs., tit. 18, § 1705(c).) It is undisputed that CDTFA produced audit reports and work papers from the prior audits of appellant; therefore, the first element is met.

With respect to the second element, in order for written advice contained in a prior audit to apply to the person’s activity or transaction in question, the facts and conditions relating to the activity or transaction must not have changed from those which occurred during the period of operation in the period audit. (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. (Cal. Code Regs., tit. 18, § 1705(c).) Here, it is undisputed that appellant reported tax on 10 percent of its total optional maintenance charges in the second and third prior audits. It appears this 10-percent ratio originated with the first prior audit.

In the first prior audit CDTFA determined that appellant was liable for tax measured by its cost of repair parts furnished in connection with its maintenance contracts. Appellant failed to maintain or produce formal books or records and, as a result, CDTFA calculated appellant's cost price for these items based on the information available. It so happened, in the first audit, that appellant's total cost price for all repair parts was 10 percent of the total charges to its customers. There is no evidence in the available audit work papers that CDTFA ever advised appellant that it could report using a taxable ratio of 10 percent in perpetuity, regardless of appellant's actual taxable measure (i.e., cost price of repair parts).

Both of the subsequent audit reports note that appellant continued to use the 10 percent ratio from the first prior audit. Furthermore, both of the subsequent audit reports included the following disclaimer: "No detailed examination of costs was conducted. This percentage was determined in the prior audit." Nevertheless, it is further clear that the facts and circumstances have since changed. Specifically, the ratio of cost to total contract price has now increased beyond 10 percent. There is no evidence in the prior audit reports or work papers that CDTFA ever advised appellant that the measure of tax for an optional maintenance contract is 10 percent of the total charge. To the contrary, the fact that the audit reports for the second and third audit both state that the auditor did not do a detailed examination of the cost price suggests otherwise. These reports are sufficient to place appellant on notice that the measure of tax is appellant's cost and the overall 10-percent cost ratio was not verified in the second or third prior audits.

In summary, we find that the facts and conditions relating to the activity have changed since the first audit, and CDTFA advised appellant that it did not examine the specific aspect of the transaction at issue in the second and third audit or verify whether the 10-percent taxable

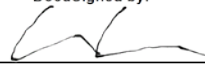
ratio was still correct. Therefore, there is no statutory basis to grant relief of the liability pursuant to R&TC section 6596.

HOLDING

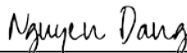
Appellant has failed to establish that it is entitled to relief of the liability.

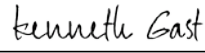
DISPOSITION

CDTFA’s action in denying the petition for redetermination is sustained.

DocuSigned by:

3CAD62FB4861CB
Andrew J. Kwee
Administrative Law Judge

We concur:

DocuSigned by:

4D465973FB44469...
Nguyen Dang
Administrative Law Judge

DocuSigned by:

FD75A3136CB34C2...
Kenneth Gast
Administrative Law Judge

Date Issued: 2/4/2020