



**OFFICE OF THE CITY AUDITOR**  
Long Beach, California

LAURA L. DOUD, CPA  
City Auditor

November 15, 2010

**California Sales and Use Tax Review**

The Office of the City Auditor is pleased to provide you with the attached report "City of Long Beach California Sales and Use Tax Review" for the period January 1, 2006 through December 31, 2008.

To ensure the City is not overpaying sales and use tax and to recover any overpayments made, the Office of the City Auditor engaged the services of state and local tax experts Downey Smith Fier (DSF) to perform a review of the City's sales and use tax payments.

Overall, the City is appropriately paying and accruing the correct amount of sales and use tax. However, the review found that the City overpaid tax for certain purchases, specifically service contracts for computer systems, chemicals resold in water, software maintenance, and construction services. As a result of the review, the City received a tax refund in FY 2010 of \$134,097 (\$125,045 plus interest), which was allocated to the Internal Services Fund (\$86,031), the General Fund (\$32,062), and Water Fund (\$15,734). The attached report provides additional information on the tax overpayments.

CITY AUDITOR

Attachment



## **"City of Long Beach"**

### California Sales & Use Tax Review

Period:  
1/1/2006 to 12/31/2008

*Prepared by:*



**DOWNEY-SMITH-FIER**  
STATE & LOCAL TAX





**DOWNEY SMITH FIER**  
STATE & LOCAL TAX

**City of Long Beach**  
*California Sales & Use Tax*

**Verification Comments**

The following information summarizes the sales and use tax refunds identified by Downey Smith Fier (DSF) as part of the overpayment review for the period January 1, 2006 to December 31, 2008, including the applicable refund periods, supporting records and our methodology to quantify and support the claim for refund filed on behalf of the City of Long Beach (LB).

**Overview**

Prior to reviewing accounts payable invoices, DSF obtained electronic accounts payable data from the Financial Management department for the review period. An analysis of the data identified the types of purchases by LB and the primary vendors used, which enabled us to focus our review on the material dollars. Additionally, the data was separated by the various departments within LB as several departments perform their own accounts payable function including the storage of records. A detailed review of LB's sales and use tax returns and related supporting documentation was also performed to identify the areas and departments where use tax was self-accrued.

Based on the potential refund areas identified in DSF's review of the returns and accounts payable data, DSF examined the original source documents at each department including purchase invoices, purchase orders and related contracts. Where necessary, DSF also contacted LB's vendors to obtain additional information related to specific transactions to determine the taxability. The total tax overpayments identified by DSF and subsequently approved by the Board of Equalization was \$125,045, plus additional credit interest of \$9,052.14. The findings are summarized below based on the various overpayment areas.

**Optional Warranties/Service Contracts (Tax Refund: \$ 80,475)**

During the review period, LB purchased a significant amount of computer and server systems from Dell. The purchases were structured so that rather than pay the sales or use tax to Dell, LB self reported the use tax to the Board of Equalization as part of their sales and use tax returns. LB reported use tax on the entire purchase amount, which was consistent with how Dell would have billed tax during this time period.

The computer systems purchased from Dell included non-taxable optional (extended or upgraded) warranties and/or service contracts. However, because Dell invoices their computer systems for a lump sum price, their long standing policy was to tax the service contract piece as part of the sale of the computer systems. In 2008, the appeals court ruled in *Dell, Inc. v The Superior Court of the City and County of San Francisco* that the service contracts were not subject to sales or use tax.

As Dell's invoices do not separately itemize the price of each component of their computer systems, it is impossible to determine the price allocated to the exempt services portion by looking at the invoice. Accordingly, we contacted Dell to obtain additional information to calculate the exempt services associated with the purchases by LB. Using the itemized pricing we received from Dell, a refund was requested for the actual amounts allocated to the exempt services. As it turned out, the overall non-taxable portion was approximately 25% of the total purchase price. This non-taxable percentage could vary based on the types of systems and services purchased by LB prospectively. As a result of the court case, Dell stopped collecting sales or use tax on the value assigned to the optional warranties and services in early 2008.



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**Exempt Services (Tax Refund: \$ 28,311)**

A detailed review of the Financial Management department's use tax accruals identified overpayments of use tax on purchases of various exempt services including software consulting services, construction services and installation.

*Software Consulting Services*

Software consulting services were purchased from Compudyne Public Safety & Justice with milestone payments at various stages of completion in accordance with the contract. While LB correctly did not report use tax on the majority of the milestone payments, use tax was over-reported on the initial payment. Additionally, Compudyne is a California vendor and was registered to collect sales and use tax on transactions where applicable.

*Construction Services*

In 2006, LB purchased a video surveillance system from Celplan Technologies that included equipment and related professional services such as design, installation and training. The invoices were issued at various stages of the project based upon the contract terms. Each of the invoices allocated the amount billed between the equipment and professional services. As additional support for the price of the non-taxable services, itemized pricing detail was located with the original contract information.

*Exempt Installation*

In 2007, LB purchased five electronic battery charging stations for the Long Beach Airport from Etec who also installed the charging stations. The price of the installation services was separately stated on the invoice. Note, installation charges in California are exempt from sales or use tax whether or not they are separately stated.

**Chemicals Resold in Water (Tax Refund: \$ 14,637)**

A review of the water department's use tax accruals revealed that LB reported use tax on several purchases of chemicals used to treat the water resold to LB customers, including chlorine and aluminum sulfate. For California sales and use tax purposes, these chemicals become a component part of the water resold by LB and therefore can be purchased by LB for resale. The aluminum sulfate was purchased from General Chemical and the chlorine was purchased from JCI Jones Chemicals.

**Optional Software Maintenance (Tax Refund: \$ 1,586)**

LB purchased optional software maintenance from Emphasys, a vendor located in Michigan in 2006. Although Emphasys was located in Michigan, they were registered to collect California sales and use tax and collected tax on 100% of the sales price. For California sales and use tax purposes, optional software maintenance is considered to be both the sale of software (updates and error corrections) and the sale of support services, exempt from tax. Accordingly, California deems 50% of the purchase price as a non-taxable purchase of services.

If information is available to document there was no transfer of tangible media (CD, tape, etc.) during the maintenance period the entire sale is exempt. Although we were unable to document if any tangible media was delivered during the maintenance term, a refund was allowed on 50% of the purchase price. As the vendor was located outside California and collected use tax on the transaction, we were able to recover the overpayment directly from the State.