OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18043013
	) CDTFA Acct. No. 101-349543
KARIHAN FILIPINO FOODS CORPORATION	) CDTFA Case ID: 867151
	)
	) Date Issued: August 27, 2019
	)

OPINION

Representing the Parties:

For Appellant:	Alberto L. Prado, President
For Respondent:	Scott A. Lambert, Hearing Representative
For Office of Tax Appeals:	Deborah Cumins, Business Taxes Specialist III

J. ANGEJA, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, appellant Karihan Filipino Foods Corporation (appellant) appeals a decision issued by the respondent California Department of Tax and Fee Administration (CDTFA),[1] denying appellant's timely petition for redetermination of a Notice of Determination (NOD) which proposed a liability of $169,293.28 of additional tax, a fraud penalty of $42,323.51, and applicable interest, for the period January 1, 2010, through September 30, 2013.

Appellant waived its right to an oral hearing and, therefore, the matter is being decided based on the written record.

ISSUES

1. Whether a reduction is warranted to the measure of underreported taxable sales.
2. Whether CDTFA has provided clear and convincing evidence of fraud.

[1] Sales taxes were formerly administered by the State Board of Equalization (Board). In 2017, functions of the Board relevant to this case were transferred to CDTFA. (Gov. Code, § 15570.22.) For ease of reference, when referring to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to the Board; and when referring to acts or events that occurred on or after July 1, 2017, "CDTFA" shall refer to CDTFA.

FACTUAL FINDINGS

1. Since January 1, 2010, appellant has operated a cafeteria-style restaurant in National City, where customers pay for meals and pick up their food at the counter. The restaurant is open seven days a week and is closed for five holidays each year.
2. CDTFA audited appellant for the period January 1, 2010, through September 30, 2013. For the audit period, appellant reported total sales of $570,978, claimed deductions of $13,389 for sales for resale, $2,750 for exempt food sales, $9,730 for nontaxable labor, $17,747 for sales tax reimbursement, $2,250 for tele-production charges,[2] and reported taxable sales of $525,112.
3. For the audit, appellant provided: federal income tax returns (FITR's) for 2010, 2011, and 2012; bank statements; sales and use tax return (SUTR) worksheets; cash register tapes for three days (January 6, 10, and 17, 2014); sales and use tax returns; purchase invoices; and profit and loss statements.
4. The amounts of gross receipts appellant reported on its FITR's exceeded the total sales reported on its SUTR's by $308,271 in 2010, $370,620 in 2011, and $413,491 in 2012, for a total difference of $1,092,382.
5. Appellant's claimed cost of goods sold exceeded its reported total sales by $48,091 for 2010; $87,633 for 2011; $111,867 for 2012; and $23,326 for the first quarter 2013 (1Q13) through 3Q13.
6. In the audit, CDTFA established a total deficiency measure of $1,843,306, consisting of the following: 1) $1,092,381 for unreported taxable sales based on an analysis of federal income tax returns; 2) $715,506 for unreported taxable sales based on the credit-card-sales-ratio method; 3) $33,169[3] for disallowed claimed deductions; and 4) $2,250 for

[2] The basis on which appellant claimed a deduction for "tele-production charges" is not clear. (The Revenue and Taxation Code provides an exemption for property used in tele-production and postproduction activities (see R&TC, § 6378), but it does not appear to be applicable to appellant's business operations.) CDTFA's audit workpapers indicate that appellant claimed the deduction in error, and appellant does not protest CDTFA's disallowance of this deduction. Accordingly, we need not further address it.

[3] This amount, incorrectly labeled on the audit report as "disallowed claimed exempt sales," includes $13,389 for nontaxable sales for resale, $2,750 for exempt sales of food, $9,730 for nontaxable labor, and $7,300 for sales tax reimbursement included (for the period October 1, 2010, through September 30, 2013). The total amount disallowed is less than the total of the claimed deductions that are related to restaurant operations and are listed above of $43,616 ($13.389 + $2,750 + 9,730 + $17,747). The difference represents $10,447, which was the sales tax reimbursement claimed for the period January 1, 2010, through September 30, 2010 (no other deductions were

disallowed claimed deduction for tele-production. Appellant protests the first three measures of tax and does not protest the disallowed claimed deduction for tele-production of $2,250.

7. To establish the understatement of $1,092,381, CDTFA compared total sales reported on the SUTR's to gross receipts reported on the FITR's for 2010, 2011, and 2012, and computed that difference. Since appellant could not explain the differences for any of the years, CDTFA concluded that the entire amount represented unreported taxable sales.

8. To establish the audited understatement using the credit-card-ratio audit method, CDTFA conducted observation tests, from 8:00 a.m. to 9:30 p.m. each day on Monday, January 6, 2014, and two Fridays, January 10 and 17, 2014. For those days, CDTFA computed percentages of purchases paid by credit card to total sales of 30.24 percent, 22.52 percent, and 38.20 percent, respectively, with a weighted average for the three days of 29.03 percent.

9. Using Internal Revenue Service (IRS) Forms 1099-K,[4] CDTFA compiled credit card deposits of $589,018 for the period October 1, 2010, through September 30, 2013. CDTFA removed sales tax reimbursement to compute credit card sales of $540,199 for the period October 1, 2010, through September 30, 2013,[5] which it divided by 0.2903 to compute audited taxable sales of $1,860,775 (rounded) for the period October 1, 2010, through September 30, 2013. CDTFA computed that audited taxable sales of $1,860,775 exceeded reported taxable sales of $418,002 by $1,442,773 for the period October 1, 2010, through September 30, 2013.

10. To avoid duplication among the audit items, CDTFA reduced that amount by $861,179, the difference between SUTR's and FITR's that was included as a separate understatement of reported taxable sales for those three years, and by the disallowed deductions of $35,419 during the period, and computed unreported taxable sales based on

claimed for that period). Since the understatement for those three quarters was established using a percentage of error in reported taxable sales, a separate disallowed deduction would be duplicative.

[4] Federal Form 1099-K, "Payment Card and Third Party Network Transactions," is a form used by credit card companies and third-party processors (payment settlement agencies) to report the gross amount of reportable payments made to the taxpayer by the payment settlement agency.

[5] Since customers picked up their food at the counter, there were no tips, and it was not necessary to reduce credit card receipts for tips included therein.

the credit-card-sales-ratio method for each quarter within the period October 1, 2010, through September 30, 2013. In its quarterly comparison, CDTFA found that, for the fourth quarter of 2011 and first quarter 2012, reported taxable sales exceeded audited amounts. Thus, for those two quarters, CDTFA did not establish unreported taxable sales based on the credit-card-sales-ratio method. Further, it added back those negative differences.

11. In sum, for the period October 1, 2010, through September 30, 2013, CDTFA computed unreported taxable sales based on the credit-card-sales-ratio method of $558,396,[6] which represented an error rate of 133.59 percent. CDTFA applied 133.59 percent to reported taxable sales for the first three quarters of 2010 to compute unreported taxable sales of $157,111 for that period. CDTFA added $558,396 and $157,111 to compute the understatement of $715,506 (rounded).

12. Regarding the claimed deductions, appellant stated that the amounts claimed for sales for resale and for exempt food sales both represented sales for resale to other restaurants. However, appellant had no explanation for the claimed deduction for nontaxable labor. Appellant asserted that the deductions for sales tax reimbursement were properly claimed, but did not provide sales tax worksheets that showed sales tax reimbursement was included in reported total sales. Since appellant did not provide documentation to support any of the claimed deductions, CDTFA disallowed them.

13. Based on the foregoing, CDTFA issued the above-described NOD in this matter. Appellant filed a timely petition for redetermination, and on August 7, 2017, CDTFA issued a Decision and Recommendation, denying appellant's petition for redetermination.

14. This timely appeal followed.

DISCUSSION

Issue 1 – Whether a reduction is warranted to the measure of underreported taxable sales.

The California sales tax is imposed on a retailer's retail sales in this state of tangible personal property, unless the sale is specifically exempt or excluded from taxation by statute.

[6] We have reviewed CDTFA's computations to add back the negative differences and find that the understatement for the period October 1, 2010, through September 30, 2013, was miscalculated. The amount should be $579,119 ($1,442,773 - $861,179 difference between FITR's and SUTR's - $35,419 disallowed deductions + $32,944 to add back negative differences). Since that amount exceeds the understatement established by CDTFA and is in appellant's favor, it will not be discussed further.

(R&TC, § 6051.) All of a retailer's gross receipts are presumed subject to tax, unless the retailer can prove otherwise. (R&TC, § 6091.) It is the retailer's responsibility to maintain complete and accurate records and to make them available for examination. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).)

When CDTFA is not satisfied with the amount of tax reported by the taxpayer, or in the case of a failure to file a return, CDTFA may determine the amount required to be paid on the basis of any information which is in its possession or may come into its possession. (R&TC, §§ 6481, 6511.) In the case of an appeal, CDTFA has a minimal, initial burden of showing that its determination was reasonable and rational. (See *Schuman Aviation Co. Ltd. v. U.S.* (D. Hawaii 2011) 816 F.Supp.2d 941, 950; *Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Michael E. Myers* (2001-SBE-001) 2001 WL 37126924.) Once CDTFA has met its initial burden, the burden of proof shifts to the taxpayer to establish that a result differing from CDTFA's determination is warranted. (*Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 616.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (See *ibid.*; see also *Appeal of Aaron and Eloise Magidow* (82-SBE-274) 1982 WL 11930.)

Here, appellant provided incomplete records for audit; its gross receipts reported on its FITR's exceeded the total sales reported on its SUTR's, and its claimed cost of goods sold exceeded its reported total sales throughout the audit period. Each of these is a sufficient reason to question the reliability of appellant's reported taxable sales. (R&TC, § 6481.) Accordingly, we find that CDTFA was justified in questioning the reliability of appellant's reported taxable sales, and computing appellant's taxable sales using alternate methods.

CDTFA used alternate audit methods including a credit-card-sales-ratio, a comparison of appellant's FITR's and SUTR's, and a disallowance of unsupported claimed nontaxable sales, to determine the audit liability at issue herein. The credit-card-sales-ratio is an effective method for establishing total sales because the basis of the computations is the amount of credit card receipts, which can be established with a high level of confidence since the information is compiled from an objective source (in this case from 1099-K forms reported to the IRS). For this audit, CDTFA conducted three full days of testing and computed credit card sales to total sales ratios of 30.24, 22.52, and 38.20 percent, with a weighted average of 29.03 percent. We find that three days of testing is adequate to establish a representative ratio of credit card sales to total sales, and we note there are no significant aberrations in the ratios for the three days.

Moreover, CDTFA's use of appellant's own income tax returns, on which appellant reported gross receipts from its sales, is reasonable. Accordingly, we conclude that CDTFA has established that its determination is reasonable and based on the best-available evidence, and accordingly the burden shifts to appellant to provide evidence from which a more accurate determination may be made.

In its opening brief, appellant states, "…three days of audit does not represent the 365 days of sales especially a Filipino restaurant in National City, with a lot of competition." We infer that appellant is disputing the three-day observation test CDTFA used to establish the audited percentage of credit card sales to total sales; however, to satisfy its burden of proof, a taxpayer must prove both: (1) the tax assessment is incorrect, and (2) the proper amount of the tax. (*Honeywell, Inc. v. State Bd. of Equalization* (1982) 128 Cal.App.3d 739, 744.) Appellant's unsupported assertion meets neither of these conditions, and thus, is insufficient to establish that adjustments are warranted.

In addition, appellant contends that some of its sales were nontaxable sales for resale. In its opening brief, appellant asserts that it made sales for resale of meats, fish, squid, vegetables, fruits, and store supplies to other restaurants, markets, cafés and bakeries. Appellant has provided a list of 11 customers, with amounts of sales allegedly made for resale to each of these customers, which total $283,495. Each amount of sales on the list is a total for a year or partial year. Appellant has listed seller's permit numbers for nine of the customers. Apparently, appellant is arguing that the total measure of tax of $1,843,306 should be reduced by $283,495 for sales for resale.

The burden of proving that a sale of tangible personal property is not at retail is upon the seller unless the seller timely takes in good faith a certificate from the purchaser that the property is purchased for resale. (R&TC, § 6091.) If the seller does not timely obtain a valid and complete resale certificate, the seller will be relieved of liability for the tax only where the seller shows that the property was: 1) in fact resold by the purchaser and was not used by the purchaser for any purpose other than retention, demonstration, or display while holding it for sale in the regular course of business; 2) is being held for resale by the purchaser and has not been used for any purpose other than retention, demonstration, or display, while being held for sale in the regular course of business; or 3) was consumed by the purchaser and tax was reported by the

purchaser directly to CDTFA on the purchaser's returns or in an audit of the purchaser. (Cal. Code Regs., tit. 18, § 1668 (e).)

Appellant has not provided copies of sales invoices or sales receipts that were issued to customers for the listed sales. Thus, there is no evidence that appellant actually made sales to these 11 retailers. Further, appellant has not provided resale certificates from any of the customers to whom it allegedly made nontaxable sales for resale. Absent timely, valid resale certificates, taken in good faith, appellant bears the burden of showing that the property was in fact resold. (Cal. Code Regs., tit. 18, § 1668(e).) Appellant's list of alleged sales to the 11 retailers, without proof that those retailers actually resold the property at issue, is insufficient to support appellant's argument regarding sales for resale.

For the foregoing reasons, we conclude that appellant has failed to meet its burden of establishing that reductions to the audit liability are warranted.

Issue 2 – Whether CDTFA has shown, by clear and convincing evidence, that all or part of the deficiency was due to fraud or the intent to evade the payment of tax.

R&TC section 6485 provides that if any part of the deficiency for which a deficiency determination is made is due to fraud or an intent to evade the Sales and Use Tax Law or authorized rules and regulations, a penalty of 25 percent of the amount of the determination shall be added thereto. CDTFA must establish fraud by clear and convincing evidence. (Cal. Code Regs., tit. 18, § 1703(c)(3)(C).) Fraud is intentional wrongdoing on the part of the taxpayer with the specific intent to avoid a tax known to be owing. (*Bradford v. Commissioner* (9th Cir. 1986) 796 F.2d 303, 307 (*Bradford*).) Fraud must be established by clear and convincing evidence. (*Cal. State Bd. of Equalization v. Renovizor's Inc.* (9th Cir. 2002) 282 F.3d 1233, 1241; *Marchica v. State Bd. of Equalization* (1951) 107 Cal.App.2d 501, 508; see also Cal. Code Regs., tit. 18, § 1703 (c)(3)(C).)

Although fraud may not be presumed, it is rare to find direct evidence that fraud has occurred, and thus it is often necessary to make the determination based on circumstantial evidence. (*Bradford*, *supra,* 796 F.2d at p. 307.) Certain facts or actions are by nature evidence of a deliberate attempt to evade the payment of tax, including understatement of income and inadequate records. (*Bradford, supra,* 796 F.2d at p. 307.)

Here, appellant's own records indicate that appellant was aware of its substantial underreporting. Specifically, during the audit period, appellant reported over $1,000,000 more in

gross receipts on its FITR's than it did on its sales tax returns; its claimed cost of goods sold exceeded its reported sales by over $270,000 during that time; and appellant's bank deposits exceeded its reported taxable sales by over $920,000. Appellant's president and sole corporate officer, Mr. Alberto Prado, was actively involved in appellant's daily operations, had full financial control over appellant, made bank deposits, and filed appellant's sales and use tax returns. Therefore, Mr. Prado had actual knowledge of appellant's underreporting. Appellant, a corporation, can only act through its officers or principals, and thus Mr. Prado's knowledge and actions are imputed to appellant. (See *FMC Corp. v. Plaisted & Companies* (1998) 61 Cal.App.4th 1132, 1213.)

In addition, appellant consistently and substantially underreported its sales by an average of 351 percent over the course of the audit, which is strong evidence of fraud. Moreover, appellant consistently underreported its sales in each of the 15 quarters of the audit period, or nearly 4 years. This pattern of underreporting is also strong evidence of fraud. (*Baumgardner v. Commissioner* (9th Cir. 1957) 251 F.2d 311, 322.)

Appellant has not specifically addressed the penalty in its opening brief. However, during the appeals process with CDTFA, appellant argued that the fraud penalty was not warranted because there was no understatement. In light of our finding that no adjustments are warranted to the audited understatement, we reject this argument.

In sum, the evidence clearly establishes that appellant's own records provided it with actual knowledge of appellant's correct sales tax liability and reporting obligations. Despite such knowledge, appellant substantially and consistently underreported its taxable sales. We find that CDTFA has provided clear and convincing evidence of fraud and that the penalty has been properly applied.

HOLDINGS

1. No adjustment is warranted to the measure of underreported taxable sales.
2. CDTFA has provided clear and convincing evidence of fraud, and the fraud penalty was properly applied.

DISPOSITION

CDTFA's denial of the petition for redetermination is sustained.

DocuSigned by:
Jeff Angeja
0D390BC3CCB14A9...

Jeffrey G. Angeja
Administrative Law Judge

We concur:

DocuSigned by:
8B585BFAC08946D...

Linda C. Cheng
Administrative Law Judge

DocuSigned by:
Nguyen Dang
4D465973FB44469...

Nguyen Dang
Administrative Law Judge