OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18032425
	) CDTFA Account No. 101-250967
J.E.P. ENTERPRISES, INC.	) CDTFA Case ID 838270
	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Juan Guzman, CPA
For Respondent:	Lisa Renati, Hearing Representative Jason Parker, Headquarters Operations Chief Christopher Brooks, Tax Counsel IV
For Office of Tax Appeals:	Lisa Burke, Business Taxes Specialist III

J. ANGEJA, Administrative Law Judge: Pursuant to California Revenue and Taxation Code (R&TC) section 6561, J.E.P. Enterprises, Inc. (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] denying appellant's petition for redetermination of the Notice of Determination (NOD) issued on June 30, 2014. The NOD proposed to assess a tax liability of $220,066.49, plus accrued interest, and a fraud penalty of $55,016.65 for the period April 1, 2010, through September 30, 2013 (audit period).

Office of Tax Appeals (OTA) Administrative Law Judges Josh Lambert, Linda C. Cheng, and Jeffrey G. Angeja, held an oral hearing for this matter in Cerritos, California, on January 23, 2020. At the conclusion of the hearing, the record was closed and this matter was submitted for decision.

[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.) When referring to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to its predecessor, the board.

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.

FACTUAL FINDINGS

1. Appellant has operated a Mexican-style restaurant with a bar in Riverside, California since July 2009, and in May 2012, appellant also began operating a food booth in Chico, California. From April 2005 through June 2009, the restaurant was operated as a sole proprietorship by appellant's president and sole stockholder. From September 1999 through March 2005, appellant's president also operated a used car dealership. None of the businesses operated by appellant or its president had been audited previously.
2. The restaurant has seating for approximately 70 people, and is open daily from 11:00 a.m. to 9:00 p.m. There also is a large bar area with a dance floor, which opens daily at 3:00 p.m. Customers can order food for consumption in the bar area.
3. Appellant used handwritten guest checks to take orders, and on each guest check, appellant separately stated sales tax properly computed as a percentage of the total sale amount.
4. For the audit period, appellant reported total sales of $488,855, and did not claim any deductions, resulting in reported taxable sales of $488,855.
5. Upon audit, appellant only provided bank statements for most of the audit period. Later, appellant provided daily sales summaries for the periods October 1, 2013, through October 20, 2013, and November 13, 2013, through November 26, 2013. Appellant did not provide any source documents, such as cash register z-tapes and guest checks, to support the accuracy of the daily sales summaries, even after CDTFA had made multiple requests for the source documentation.
6. Based on the available bank statements, CDTFA compiled deposits from sales of $1,900,165, after adjustments to exclude sales tax reimbursement, for the period July 1, 2010, through September 30, 2013. The bank deposits from sales exceeded appellant's reported taxable sales for the same period by $1,448,018.
7. CDTFA computed that 83.26 percent of appellant's bank deposits were from credit cards, and 16.74 percent of the deposits were cash. Because there were significant fluctuations

in the amounts of cash deposits from month to month, and no cash deposits for two months (July 2013 and September 2013), CDTFA concluded that appellant had not deposited all of its cash proceeds into the bank, and thus, appellant's bank deposits did not represent all of its sales. Therefore, CDTFA used the credit-card-sales-ratio method to establish audited taxable sales.

8. CDTFA intended to use the daily sales records that appellant was asked to maintain to compute an average ratio of credit card sales to total sales (credit-card-sales ratio). However, because appellant failed to comply with CDTFA's request for source documents, such as guest checks and cash register z-tapes, to support the accuracy of the daily sales summaries it provided, the daily sales summaries were unreliable.

9. CDTFA performed site observation tests to determine an average credit-card-sales ratio. CDTFA observed appellant's business for two days: Tuesday, October 22, 2013, and Tuesday, November 12, 2013, from the time the business opened until it closed. For those two days combined, CDTFA computed that credit card payments, including sales tax reimbursement and tips, represented 57.56 percent of taxable sales, excluding sales tax reimbursement and tips. CDTFA divided total credit card deposits for the audit period by 57.56 percent to establish audited taxable sales of $3,193,983, which exceeded appellant's reported taxable sales by $2,705,128. CDTFA divided the understatement into two audit items, unreported taxable sales of $1,448,018 established based on appellant's bank deposits, and additional unreported taxable sales of $1,257,110 established based on the credit-card-sales-ratio analysis.

10. Appellant's president was involved in the restaurant's daily operations, added sales tax reimbursement to all of appellant's sales, and prepared all of appellant's sales and use tax returns.

11. The underreporting of taxable sales was consistent and systematic throughout the audit period.

12. In the NOD issued on June 30, 2014, CDTFA included a 25-percent penalty for fraud.

13. Appellant timely filed a petition for redetermination, which CDTFA denied. This appeal followed.

DISCUSSION

Issue 1 - Whether any reduction to the measure of unreported taxable sales is warranted.

California imposes a 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.) All of a retailer's gross receipts are presumed subject to tax, unless the retailer can prove otherwise. (R&TC, § 6091.) Although gross receipts from the sale of "food products" are generally exempt from the sales tax, sales of hot food and sales of food served in a restaurant are subject to tax. (R&TC, § 6359(a), (d)(1), (d)(2), and (d)(7).)

When CDTFA is not satisfied with the amount of tax reported by the taxpayer, 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 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 Magidow* (82-SBE-274) 1982 WL 11930.)

Here, the only records provided by appellant for examination were bank statements and unsupported daily sales summaries for approximately five weeks after the audit had commenced. Although CDTFA states that it made multiple requests for source documents, such as cash register z-tapes and guest checks, appellant failed to provide any source documentation. CDTFA found that appellant's bank deposits from sales exceeded its reported taxable sales for the same period by $1,448,018, which constitutes strong evidence that appellant had underreported its taxable sales by at least that amount. Given that appellant had deposited relatively small amounts of cash, with no cash deposits in two months, we find that it was reasonable for CDTFA to question whether the bank deposits represented all of appellant's sales. Since the only reliable records available were the credit card deposits recorded in appellant's bank statements, we find that CDTFA was justified in using the credit-card-sales-ratio method to establish audited taxable

sales. Therefore, the burden of proof is on appellant to establish by documentation or other evidence that a reduction to the amount of audited taxable sales is warranted.

Appellant contends that audited taxable sales are unreasonably high, noting that audited taxable sales of $3,193,983 represent average daily taxable sales of $2,535, whereas CDTFA's two-day observation test shows average daily taxable sales of only $1,175. Appellant argues that CDTFA would have found a higher ratio of credit card sales to total sales if it had conducted site observation tests on weekends when families are more likely to eat at the restaurant and pay with credit cards because the ticket prices are higher. Appellant asserts that the CDTFA Audit Manual specifically requires CDTFA to perform other audit procedures to verify that audit results are reasonable whenever the audit results are based on an alternative audit method, such as a credit-card-sales-ratio analysis. Because CDTFA did not verify that the audit results are reasonable by performing other audit procedures in this case, appellant contends that unreported taxable sales in excess of the amount established from bank deposits should be deleted. Appellant also contends that the summary records it provided for the period October 1, 2013, through October 20, 2013 yield a lower and more accurate deficiency measure of approximately $2 million instead of the $2.7 million measure determined by CDTFA.

As stated above, we concluded that CDTFA met its burden of establishing that its determination was reasonable and rational, based on the paucity of evidence appellant provided.[2] Therefore, the burden of proof shifts to appellant to establish by documentation or other evidence that a reduction to the amount of audited taxable sales is warranted. Appellant has failed to provide any such evidence, and appellant's mere complaints of CDTFA's audit methodology are insufficient to meet appellant's burden of proof. Likewise, appellant's summary records for the above-referenced 20-day period lack any supporting documentation (such as guest checks, cash register tapes, or Z-tapes), and therefore we give little weight to them. As a result, they are insufficient to establish that any reductions to the deficiency measure are warranted. Thus, we conclude that no adjustments to the audited taxable measure are warranted.

[2] For example, we note that appellant has not explained why it failed to comply with CDTFA's request that it maintain and provide its guest checks and cash register tapes for a test period. If appellant had complied with CDTFA's request, CDTFA could have computed an average credit-card-sales ratio from a test period of two or three weeks, which may have been more representative of appellant's sales, generally, than a credit-card-sales ratio computed from site observation tests for only two days.

Issue 2 - Whether CDTFA has provided clear and convincing evidence of fraud.

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; 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; *Tenzer v. Superscope, Inc.* (1985) 39 Cal.3d 18, 30.) Where there is a substantial deficiency that cannot be explained satisfactorily as being due to an honest mistake or to negligence and where the only reasonable explanation is a willful attempt to evade the payment of tax, the penalty for fraud or intent to evade the tax should apply. (*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 falsified records and failure to follow the requirements of the law, the knowledge of which is evidenced by permits or licenses held by the taxpayer in prior periods. (*Bradford, supra,* 796 F.2d at p. 307.) Circumstantial evidence of intent to evade taxation includes, but is not limited to: substantial discrepancies between recorded amounts and reported amounts which cannot be explained (the indication that a deficiency is due to intent to evade increases in direct proportion to the ratio of the understatement); tax or tax reimbursement properly charged, evidencing knowledge of the requirements of the law, but not reported; inadequate records; failure to cooperate with tax authorities (*Bradford, supra,* 796 F.2d at p. 307); and consistent, substantial understatements of income (*Powell v. Granquist* (9th Cir. 1958) 252 F.2d 56, 60).

On appeal, appellant asserted that it lacked even a general knowledge of sales and use tax reporting obligations, and that appellant's principal only spoke English as a second language. Appellant also referred to CDTFA's Audit Manual and Compliance Policy Manual, citing generic examples in which a fraud penalty was not imposed based on various hypothetical

situations. However, appellant did not address the specific facts of this case as they relate to the fraud penalty, which we address below.

Here, appellant consistently and systematically underreported its taxable sales throughout the audit period. In addition, appellant's underreporting resulted in an egregious error ratio of 553.36 percent (unreported taxable sales of $2,705,128 ÷ reported taxable sales of $488,855) for the audit period, which is strong evidence of fraud.

Furthermore, appellant's own records indicate that appellant was aware of its substantial underreporting. Specifically, appellant used handwritten guest checks to take orders, and on each guest check, appellant separately stated sales tax properly computed as a percentage of the total sale amount. On its sales and use tax returns, appellant reported all sales as taxable sales. Thus, the evidence indicates that appellant knew that all of its sales were taxable and collected sales tax reimbursement on all of its sales. Despite such knowledge, appellant's bank deposits exceeded reported taxable sales by $1,448,018 for the period July 1, 2010, through September 30, 2013, which represents an error ratio of 320.25 percent ($1,488,018 ÷ $452,147) when compared to reported taxable sales for the same period. Appellant's failure to report such a substantial portion of the sales recorded in its own bank statements is egregious. Given that appellant knew that all of its sales were taxable, and nevertheless reported less than one-fourth of its sales deposits on its sales and use tax returns ($488,855 ÷ $2,705,128), we conclude that the magnitude of the understatement is clear evidence of appellant's intent to evade the payment of tax.

Moreover, appellant provided virtually no records to support its reported sales amounts. Even after CDTFA had asked appellant to maintain cash register z-tapes and guest checks for the periods October 1, 2013, through October 20, 2013, and November 13, 2013, through November 26, 2013, appellant provided neither cash register z-tapes nor guest checks for either period. We find that the lack of records for the audit period, and appellant's failure to maintain and provide records for brief periods upon request is additional evidence of appellant's willful attempt to evade the payment of tax.

Based on the foregoing, we find that there is clear and convincing evidence that appellant intended to evade the payment of tax that it collected and knew was due. Thus, we conclude that the fraud penalty was properly imposed.

HOLDINGS

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

DISPOSITION

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

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Jeff Angeja
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Jeffrey G. Angeja
Administrative Law Judge

We concur:

DocuSigned by:
Josh Lambert
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Josh Lambert
Administrative Law Judge

DocuSigned by:
Linda C. Cheng
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Linda C. Cheng
Administrative Law Judge

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