OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18083529
	) CDTFA Account No. 099-136705
M. SILVA	) CDTFA Case ID 936270
	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	M. Silva, Taxpayer Terrence J. Moore, Attorney Jaime F. Tricerri, Representative
For Respondent:	Scott Lambert, Hearing Representative Lisa Renati, Hearing Representative Dana Flanagan-McBeth, Tax Counsel IV
For Office of Tax Appeals:	Lisa Burke, Business Taxes Specialist III

J. LAMBERT, Administrative Law Judge: Pursuant to California Revenue and Taxation Code (R&TC) section 6561, M. Silva (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 January 29, 2016. The NOD assessed a tax liability of $803,262.92, plus accrued interest, and a fraud penalty of $200,815.82 for the period April 1, 2010, through March 31, 2015 (audit period). On appeal, CDTFA concedes the liability for the period April 1, 2010, through March 31, 2012. Therefore, the remaining amounts in dispute are the tax liability, accrued interest, and fraud penalty for the period April 1, 2012, through March 31, 2015 (liability period).

[1] Sales taxes were formerly administered by the State 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.

Office of Tax Appeals (OTA) Administrative Law Judges, Josh Lambert, Linda C. Cheng, and Nguyen Dang, 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.

ISSUES

1. Whether further adjustments are warranted to the determined measure of tax.
2. Whether the fraud penalty was properly imposed.

FACTUAL FINDINGS

1. Appellant operated three restaurants (Cactus restaurants) offering Mexican-style cuisine and catering services during the liability period. Appellant has been in business since September 30, 1992.
2. The third Cactus restaurant opened in June 2013. On September 2, 2014, appellant began operating a juice bar restaurant that offered hot and cold sandwiches, snacks, and carbonated beverages, as well as juices. Two of the Cactus restaurants and the catering business accepted only cash payments. Appellant reported all of her sales as taxable sales until she opened the juice bar restaurant.[2]
3. From August 2014 through March 2015, prior to notifying appellant that her account had been selected for audit, CDTFA conducted a covert investigation of appellant's business, making numerous cash purchases from each of appellant's locations. Sales tax was separately stated on the receipts and collected by appellant. In addition, appellant routinely kept records of guest checks and POS receipts in journals.
4. On April 8, 2015, CDTFA notified appellant that her account had been selected for audit. CDTFA continued to make purchases from appellant's restaurants. However, the receipts no longer showed an Order ID number.
5. Appellant provided her federal income tax returns for 2012 and 2013 and an incomplete set of bank statements for examination. Appellant did not provide purchase records, sales records, or source documents such as purchase invoices, cash register tapes, or receipts from her Point-of-Sale (POS) system.

[2] For the liability period, appellant reported exempt food sales of $42,917.

6. On April 21 and April 22, 2015, appellant extracted data from her POS system from April 1, 2015, through the date of extraction. The database did not include any data for dates prior to April 1, 2015.
7. Appellant explained that her technician reset the POS system every month, and saved the data onto a flash drive. Appellant stated that she misplaced the flash drive and had no backup copy.
8. The number of transactions per day shown in the extracted POS data for the period April 1, 2015, through April 22, 2015, was significantly lower than the number of transactions per day computed from the receipts obtained from August 2014 through March 2015.
9. Numerous Order ID numbers were missing from the POS data. Additionally, receipts obtained by CTDFA in April 2015 were deleted.
10. For each day during the week of May 12, 2015, through May 18, 2015, CTDFA extracted POS data at each location. CTDFA also made purchases at each location during that period and observed that at each location, the cashiers recorded sales either in the POS system or on guest checks with no consistent pattern.
11. CDTFA computed the audited number of transactions at the three Cactus locations using the Order ID from CDTFA purchases from August 2014 to October 2014.
12. For the period August 17, 2015, through November 23, 2015, appellant provided reliable POS data. CTDFA used that data to calculate the average selling price per transaction. CDTFA then adjusted the average selling price per transaction to account for a sales price increase from 2014 to 2015 using sales prices from a 2014 menu.[3]
13. CTDFA multiplied the average selling price per transaction by the number of transactions from August 2014 through October 2014 to establish audited quarterly taxable sales of $995,218 for the three Cactus restaurants.
14. For the juice bar restaurant, CTDFA computed quarterly audited sales using taxable sales from a two-day site observation.
15. CDTFA computed quarterly audited taxable catering sales using an estimate based on statements made by appellant, since she did not have any records or source documents.

[3] CDTFA also performed observation tests on two days, but the results were considered unreliable by CDTFA because appellant was promoting daily specials during those days.

16. In total, CTDFA established quarterly taxable sales of $1,026,207, which it compared to appellant's reported taxable sales of $295,012 for the fourth quarter of 2014 (4Q14) to compute a reporting error rate of 247.85 percent (($1,026,207 - $295,012) ÷ $295,012). CTDFA applied the reporting error rate to appellant's reported taxable sales for the five-year audit period to establish unreported taxable sales of $8,854,933, which is the basis for the NOD issued on January 29, 2016.

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

18. On appeal, CDTFA concedes the liability for the period April 1, 2010, through March 31, 2012. The reported taxable sales for the liability period, April 1, 2012, through March 31, 2015 (2Q12 through 1Q15), is $2,603,134.[4] The unreported taxable sales for the liability period is $6,451,867.[5]

DISCUSSION

Issue 1: Whether further adjustments are warranted to the determined measure of tax.

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

[4] Reported taxable sales for the quarters at issue total $6,451,867: (1) 2Q12: $130,160; (2) 3Q12: $128,149; (3) 4Q12: $131,871; (4) 1Q13: $146,568; (5) 2Q13: $159,361; (6) 3Q13: $232,151; (7) 4Q13: $237,682; (8) 1Q14: $257,690; (9) 2Q14: $264,895; (10) 3Q14: $284,261; (11) 4Q14: $295,012; and (12) 1Q15: $335,334.

[5] CDTFA determined underreported taxable sales totaling $6,451,867 for the quarters at issue: (1) 2Q12: $322,602; (2) 3Q12: $317,617; (3) 4Q12: $326,842; (4) 1Q13: $363,269; (5) 2Q13: $394,976; (6) 3Q13: $575,386; (7) 4Q13: $589,095; (8) 1Q14: $638,685; (9) 2Q14: $656,542; (10) 3Q14: $704,541; (11) 4Q14: $731,187; and (12) 1Q15: $831,125. The average quarterly understatement for this period is $537,656 (i.e., $6,451,867 ÷ 12.)

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, appellant failed to provide records and source documents, such as purchase invoices, cash register tapes, or receipts from her POS system for the liability period. Furthermore, appellant's POS data was erased for dates prior to April 1, 2015. Therefore, appellant had no records that CDTFA could use to verify the accuracy of her reported tax liability. As a result, CDTFA determined her audited number of transactions using data from receipts obtained during its audit from August 2014 to November 2014. To determine the average selling price per transaction, CDTFA used reliable POS data from 2015. CDTFA also made an adjustment to account for changes in sales prices from 2014 to 2015 using a 2014 menu. CDTFA's use of receipts obtained from audit and reliable POS data from outside the liability period demonstrates that its determination was not arbitrary or lacking a rational foundation and, therefore, the burden of proof shifts to appellant to show error in CDTFA's audit.

Appellant argues that CTDFA's audit methodology does not account for lower sales prices in earlier years and lower transactions before the third Cactus restaurant opened in 2013. In support, appellant prepared an alternative analysis to demonstrate that the amount of unreported taxable sales established by CTDFA is excessive. The analysis relies on menus from prior years to compute the sales price variance for those years, and bank deposits to compute the number of transactions. As a result, appellant's analysis suggests that an adjustment should be made due to lower error rates and unreported taxable sales.[6]

We disagree. Appellant's bank statements cannot be relied upon to determine the number of transactions. Two of the Cactus restaurants are cash-only and appellant has not shown that

[6] Appellant's analysis indicates error rates of: (1) 101.52 percent from 2Q12 (second quarter of 2012) to 4Q12; (2) 146.51 percent for 2013; (3) 235.34 percent from 1Q14 to 2Q14; and (4) 195.96 percent from 3Q14 to 1Q15. Appellant's analysis indicates underreported taxable sales totaling $5,050,839 for the quarters at issue: (1) 2Q12: $199,388; (2) 3Q12: $196,307; (3) 4Q12: $202,009; (4) 1Q13: $231,721; (5) 2Q13: $251,946; (6) 3Q13: $367,025; (7) 4Q13: $375,770; (8) 1Q14: $554,909; (9) 2Q14: $570,424; (10) 3Q14: $653,099; (11) 4Q14: $677,800; and (12) 1Q15: $770,441.

cash transactions were consistently deposited into the bank accounts. Appellant has not provided any corroborating documentation to establish the existence of an accurate correlation between the bank account information and the number of transactions. Additionally, appellant's calculations using the bank account statements do not account for any price variance that affected the number of deposits. On the other hand, CDTFA determined the number of transactions using the Order ID numbers from receipts purchased by CDTFA during the liability period, which is direct evidence of sales from appellant's locations. Appellant contends that the third Cactus restaurant would cause an increase in the number of transactions that is not reflected in CDTFA's calculations. However, appellant's reported taxable sales, used by CDTFA in its determination, already indicates an increase from $159,361 to $232,151 from 2Q13 to 3Q13, which is when appellant opened the third Cactus restaurant in June 2013. Additionally, when appellant opened the juice bar restaurant in September 2014, her reported taxable sales increased from $284,261 to $295,012 from 3Q14 to 4Q14. As such, appellant has not shown that an increase in the number of transactions is not already accounted for in CDTFA's calculations. Therefore, we find that appellant has not shown that the use of the bank statements is a more reliable indicator as to the number of appellant's transactions.

Appellant has not shown that her proposed price variance adjustments are warranted. Appellant's reported taxable sales from 2Q12 to 1Q15, which CDTFA used in its determination, increased from $130,160 to $335,334, and appellant has not shown that the increase in her reported taxable sales does not already account for price changes. When the same reporting error rate is applied to reported taxable sales for each quarter, as was performed by CDTFA, the increase in the number of transactions and selling prices throughout the liability period are reflected in the amount of unreported taxable sales established for each quarter. Appellant has not provided any direct records of its transactions, such as receipts or cash register tapes, for the liability period to show there is a need for further adjustments.

In summary, the error ratio computed by CDTFA from appellant's 4Q14 reported taxable sales reflects that appellant on average underreported her taxable sales in the same proportion for each quarter of the liability period, regardless of pricing or number of sales. Appellant has not shown that her reporting method or business substantially changed during the liability period, such that projection of the error ratio to any quarter of the liability period was improper (or alternatively, that a different quarter should be used to compute the error ratio). In other words,

appellant has not provided a credible explanation as to why she would have reported more of her taxable sales (as a percentage) in any given quarter than she would have during the 4Q14. Accordingly, no adjustments are warranted to unreported taxable sales.

Issue 2: Whether the fraud penalty was properly imposed.

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).)

Because fraudulent intent is rarely established by direct evidence, we may infer intent from various kinds of circumstantial evidence. These "badges of fraud" include, but are not limited to: (1) understating income; (2) maintaining inadequate records; (3) implausible or inconsistent explanations of behavior; (4) concealment of income or assets; (5) failing to cooperate with tax authorities; (6) engaging in illegal activities; (7) an intent to mislead which may be inferred from a pattern of conduct; (8) lack of credibility of the taxpayer's testimony; (9) filing false documents; (10) failing to file tax returns; and (11) dealing in cash. (*Bradford, supra*, 796 F.2d at p. 307; *Price v. Commissioner*, T.C. Memo. 2004-103.) Although no single factor is necessarily sufficient to establish fraud, the combination of a number of factors constitutes persuasive evidence. (*Price v. Commissioner*, *supra*.)

The total understatement for the liability period is $6,451,867, while appellant's reported taxable sales for the liability period is $2,603,134. Therefore, appellant reported less than 30 percent of her taxable sales, which is reflected in the significant error rate of 247.85 percent, as determined by CDTFA. Appellant's average quarterly understatement of taxable sales over the course of the liability period is $537,656. This is a substantial and consistent understatement of income over the course of three years (12 quarters), which is highly persuasive evidence of intent to defraud. (See *Powell v. Granquist* (9th Cir. 1958) 252 F.2d 56, 60).

Appellant's records are also inadequate. For the liability period, appellant did not provide any purchase records, sale records, or source documents such as purchase invoices, cash register tapes, or receipts from her POS system. Appellant's POS data for the liability period, which includes dates prior to April 1, 2015, was deleted. Appellant provided POS data from April 1, 2015, through April 22, 2015. However, this POS data was unreliable because numerous Order ID numbers were missing, receipts obtained by CDTFA were deleted, and the transactions per day were significantly lower than that computed from receipts obtained during the liability period. The only reliable POS data provided, which CDTFA relied upon, was for the period August 17, 2015, through November 23, 2015, which was outside the liability period.

Appellant's lack of any reliable records for the liability period, particularly when coupled with the fact that a substantial amount of appellant's business dealt in cash only, is indicative of an intent to defraud. (*Malicki v. Commissioner*, T.C. Memo. 1988-559 ["[t]axpayers who shun more reliable and consistent recordkeeping methods which better facilitate verification of income and/or expenses obviously sow fertile fields for fraud. Therefore, this Court must view cash transactions with a close scrutiny and much skepticism."].) Given the above, the pattern of occurrences including the deletion of POS records, sales, and Order IDs, that effectively resulted in the concealment of income from CDTFA auditors, also suggests an intent to defraud.

Appellant contends that she lacks the knowledge and education to know that sales tax was underreported. Appellant asserts that she was just a cook and did not spend many hours at the restaurants. Appellant asserts that she did not complete high school, that she has never taken accounting classes, and that she never read materials on calculating sales tax. Appellant also contends that other employees reported the sales tax and operated the POS system.

However, we find that appellant did have the requisite knowledge of tax law, such that she knew that the sales tax was being underreported. Sales tax was separately stated on the receipts and collected by appellant. In addition, appellant did not report exempt food sales until 4Q14, and the amount of reported exempt food sales was only $42,917, a minimal amount compared to her reported taxable sales. Therefore, the sales tax reported on the receipts and collected would generally be the same amounts reported and paid to CDTFA. To correctly report and pay the amounts indicated on guest checks and receipts from the POS system does not require any advanced education or knowledge of sales tax. Appellant appears to have the

knowledge required for such reporting and payment of the sales tax, as she stated during the hearing that she routinely kept records of sales from guest checks and POS receipts.

Appellant also stated that her use of guest checks led her to notice that around $10,000 had been stolen by an employee. Therefore, appellant had enough knowledge of recordkeeping to notice a discrepancy of around $10,000. Additionally, appellant successfully operated a restaurant business for many years, expanding from one to three locations and opening a juice bar; an accomplishment that strongly suggests she had a solid grasp of her business's financials. CDTFA's determination of her underreported taxable sales totaling $6,451,867 is also substantial. Under these circumstances, appellant's consistent and material underreporting of sales for the liability period cannot reasonably be attributed to mere negligence. We conclude that there is clear and convincing evidence that the audited understatement resulted from fraud or the intent to evade the payment of tax. Accordingly, we conclude that the fraud penalty was properly imposed.

HOLDINGS

1. No further adjustments are warranted to the determined measure of tax.
2. The fraud penalty was properly imposed.

DISPOSITION

CDTFA's action is modified to reflect its concession of the liability and fraud penalty for the period April 1, 2010, to March 31, 2012. CDTFA's action is otherwise sustained.

DocuSigned by:
Josh Lambert
B90E40A729E3440...
Josh Lambert
Administrative Law Judge

We concur:

DocuSigned by:
Linda C. Cheng
8B585BFAC08946D...
Linda C. Cheng
Administrative Law Judge

DocuSigned by:
Nguyen Dang
4D465973EB44469...
Nguyen Dang
Administrative Law Judge

Date Issued: 3/6/2020