OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18042996
	) CDTFA Account No. 100-517697
BREEN ENTERPRISES, INC.	) CDTFA Case ID's 774791, 823048
	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Matthew Hall, President
For Respondent:	Jason Parker, Chief Headquarters Operations Bureau
For Office of Tax Appeals:	Lisa Burke, Business Taxes Specialist III

T. STANLEY, Administrative Law Judge: Pursuant to California Revenue and Taxation Code (R&TC) section 6561, Breen Enterprises, Inc. (appellant) appeals a Decision and Recommendation (Decision) issued by the Appeals Bureau of respondent California Department of Tax and Fee Administration (CDTFA) denying, in part, appellant's petitions for redetermination of the Notice of Determination (NOD) issued on October 18, 2013, for the period July 1, 2010, through December 31, 2010 (first NOD), and the NOD issued on June 9, 2014, for the period January 1, 2011, through June 30, 2013 (second NOD). The first NOD assessed a tax liability of $17,951.16, plus accrued interest, and a penalty of $1,795.12 for negligence. The second NOD assessed a tax liability of $133,355.68, plus accrued interest, and a penalty of $33,338.95 for fraud.[1]

[1] Subsequently, CDTFA completed two reaudits for both periods. In the first reaudit, CDTFA reduced the amount of unreported taxable sales and replaced the $1,795.12 negligence penalty with a fraud penalty of $4,244.06. The second reaudit, which was completed pursuant to recommendations in the Decision, resulted in an overall reduction of $7,011.40 to the tax for the entire period July 1, 2010, through June 30, 2013 (audit period), from $151,306.84 to $144,295.44, and a fraud penalty of $36,073.91.

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

ISSUES

1. Has appellant shown that any additional reduction to the measure of unreported taxable sales is warranted?
2. Has CDTFA 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?

FACTUAL FINDINGS

1. Appellant operated a bar and grill selling beer, wine, liquor, cigarettes, and hot prepared food from January 1, 2005, through August 25, 2016, when the business was dissolved with no known successor.
2. It is undisputed that prior to the audit period under consideration here, appellant was audited for the period April 1, 2007, through March 31, 2010. In that audit, the amount of unreported taxable sales was $927,230, which represented a reporting error rate of 196.81 percent, and a negligence penalty was imposed.
3. For the audit period at issue, appellant reported total sales of $369,157, and claimed no deductions. For audit purposes, appellant provided its federal income tax returns (FITRs) for 2011 (incomplete) and 2012, some purchase invoices, and some sales reports for the period January 1, 2011, through June 30, 2013.
4. The cost of goods sold of $516,648 reported on appellant's FITRs for 2011 and 2012 substantially exceeded appellant's reported total sales of $262,333 for 2011 and 2012.
5. Gross receipts reported on appellant's FITRs for 2011 and 2012 exceeded the sales reported on its sales and use tax returns (SUTRs) by $777,672. CDTFA, therefore, established that appellant had unreported taxable sales in that amount.
6. Comparing the gross receipts reported on appellant's SUTRs with the cost of goods sold reported on the FITRs, CDTFA computed negative book markups.[2] Comparing the gross

[2] "Markup" is the amount by which the cost of merchandise is increased to set the retail price. For example, if the retailer's cost is $.70 and it charges customers $1.00, the markup is $0.30. The formula for determining the markup percentage is markup amount ÷ cost. In this example, the markup percentage is 42.86 percent (.30 ÷ .70 = 0.42857). A "book markup" (sometimes referred to as an "achieved markup") is one that is calculated from the retailer's records. Markup and gross profit margin are different. A "negative book markup" means that recorded costs exceed recorded sales.

receipts reported on appellant's FITRs to reported cost of goods sold on the FITRs, CDTFA computed book markups of 101.51 percent for 2011, 101.12 percent for 2012, and 101.30 percent for the two years combined. The book markups were significantly lower than what CDTFA expected for appellant's type of business and were approximately one-half of the audited, weighted markup (202.02 percent) calculated in the prior audit of this business.

7. To establish audited merchandise purchases, CDTFA conducted a vendor survey. The purchases reported on the 2012 FITR exceeded the total purchases from the vendor survey for 2012. Consequently, a segregation test could not be performed based on the vendor records. CDTFA did not perform a shelf test because appellant represented that the pour sizes and prices had been changed in 2014.

8. Therefore, CDTFA used the purchase ratios and markup percentages computed in the prior audit to calculate segregated alcoholic beverage sales, taxable sales of food, and taxable sales of cigarettes, which resulted in calculated audited total taxable sales of $2,236,856. The audited total taxable sales exceeded appellant's reported taxable sales for the audit period. CDTFA established unreported taxable sales of $1,090,027 based on a markup analysis (using the markup percentage established in the prior audit).

9. CDTFA computed a reporting error rate exceeding 505 percent during the audit period.

10. Appellant filed timely petitions for redetermination of both NODs.

11. Appellant had been audited previously and had been informed of the types of records required to support its reported sales. CDTFA reports that appellant stated "that it would not provide any additional records and was in the process of shredding its sales records, cash register Z-tapes, and point of sale records because it believed that providing its records would prove that it was underreporting its sales."[3]

12. CDTFA deleted the negligence penalty and in its place timely asserted an increase, pursuant to R&TC section 6563, to impose a fraud penalty.

13. CDTFA Appeals Bureau recommended a reduction of $72,384 to the amount of unreported taxable sales, to $1,791,912. Appellant timely filed this appeal.

[3] This statement was made in the Decision, based on a report by the Business Tax and Fee Division. Appellant has not submitted anything that would refute that statement. We find that appellant's failure to produce the aforementioned documents shows that it is more likely than not that the statement is accurate.

DISCUSSION

Issue 1: Has appellant shown that any additional reduction to the measure of unreported taxable sales is warranted?

California imposes a sales tax on a retailer's 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).)

It is the taxpayer's responsibility to maintain and make available for examination on request all records necessary to determine the correct tax liability, including bills, receipts, invoices, or other documents of original entry supporting the entries in the books of account. (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, 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.) 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 insufficient to satisfy that burden. (See *Appeal of Magidow* (82-SBE-274) 1982 WL 11930.)

Here, appellant failed to provide sufficient records to support the accuracy of its reported taxable sales, and the minimal records provided showed significant discrepancies. Appellant's reported total sales from its SUTRs were substantially lower than the gross receipts reported on its FITRs. The reported total sales on the SUTRs were less than the cost of goods sold reported on the FITRs. And, the book markups computed from a comparison of the gross receipts with the costs of goods sold reported on appellant's FITRs were much lower than expected. Given the discrepancies in appellant's reported amounts, the low book markups, and the inadequacy of

the books and records provided for examination, we find that CDTFA was justified in using an alternate audit method to establish audited taxable sales. Furthermore, given that the records available for the audit period were not sufficient to prepare a markup analysis, and that pour sizes and prices had been changed in 2014, precluding a shelf test, we find that it was reasonable for CDTFA to rely on the purchase ratios and markup percentages computed during the prior audit to establish audited taxable sales. 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.

With respect to appellant's contention that the gross receipts reported on its FITR's include cover charges, as well as receipts from its taxable sales of alcohol, food, and cigarettes, we note that respondent established audited taxable sales based on a markup analysis, and then reduced audited taxable sales by the amount of unreported taxable sales established based on the difference between gross receipts from the FITRs and reported total sales from the sales and use tax returns. Appellant did not provide documentation showing that cover charges were included in the gross receipts reported on its FITRs. In any event, any reduction to unreported taxable sales based on a comparison of reported gross receipts with reported total sales would have been offset by an equal increase to the amount of unreported taxable sales based on a markup analysis, with no net benefit to appellant.

CDTFA has prepared two reaudits to correct errors and to reduce audited costs of goods sold to allow for self-consumed merchandise and pilferage of cigarettes. Appellant has not identified any error in the computations or the audit procedures. Appellant has failed to meet its burden to establish by documentation or other evidence that any additional reduction to the amount of audited taxable sales is warranted. Thus, we conclude that no additional adjustments are warranted.

Issue 2: Has CDTFA 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); *State Bd. of Equalization v. Renovizor's Inc.* (9th Cir. 2002) 282

F.3d 1233, 1240-1241; *Marchica v. State Bd. of Equalization* (1951) 107 Cal.App.2d 501, 508.) 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*).)

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 commonly considered "badges of fraud" may constitute evidence of a deliberate attempt to evade the payment of tax, including understatement of income and inadequate records. (*Ibid*.) These include 1) an understatement of income, 2) inadequate records, 3) failure to file tax returns, 4) implausible or inconsistent explanations of behavior, 5) concealing assets, and 6) failure to cooperate with tax authorities. (*Ibid*. (citations omitted).)

Here, appellant made egregious understatements of its taxable sales throughout the audit period, with a 505 percent error rate. The errors made by appellant were similar to the understatements made in the prior audit period. A consistent pattern of underreporting is strong evidence of fraud. (*Baumgardner v. Commissioner* (9th Cir. 1957) 251 F.2d 311, 322.) Moreover, the reporting error rate of 505 percent is more than double the reporting error rate established in the prior audit (196.81 percent), which shows a steep decline in the accuracy of appellant's reporting from one audit period to the next. We find that the consistency of the underreporting, the magnitude of the understatement, and the marked decrease in the accuracy of reporting from one audit period to the next, is additional evidence that appellant intended to evade the payment of tax.

Appellant was notified of the types of records to maintain on multiple occasions prior to the audit at issue; when it opened its seller's permit in 2005, when the first audit was completed in 2011, and when the Decision for the prior audit was issued on July 31, 2013. Nevertheless, the records provided by appellant for examination in the audit at issue were wholly inadequate. According to CDTFA, appellant stated that it shredded its sales records, cash register Z-tapes, and point of sale records because it believed that providing its records would prove that it was underreporting its sales. It was within appellant's control to counter CDTFA's allegation by simply producing the missing records, but it did not do so. We find that appellant's failure to

provide adequate records, despite its knowledge of recordkeeping requirements, and its statement that it was destroying its records is evidence that appellant intended to evade the payment of tax.

In its petition for redetermination, appellant contends that the errors found in the audit are related to non-taxable sales and asserts that CDTFA has not met its burden in showing by clear and convincing evidence that the deficiency was due to fraud. Appellant's own records could have proven that the reporting discrepancies were related to non-taxable sales rather than to errors in reporting. Yet, it provided no additional records and may have withheld and even destroyed its records to avoid providing definitive proof of the amount of its understatement to CDTFA. Therefore, we find that the evidence of fraud is clear and convincing. Accordingly, we find that the fraud penalty was properly imposed.

HOLDINGS

1. Appellant has not established that any additional reduction to the deficiency measure of $1,791,912 is warranted.
2. CDTFA has provided clear and convincing evidence of fraud, and the fraud penalty was properly applied.

DISPOSITION

CDTFA's action in reducing the measure of tax to $1,791,912, and otherwise denying the petitions, is sustained.

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Teresa A. Stanley
Administrative Law Judge

We concur:

DocuSigned by:
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Josh Aldrich
Administrative Law Judge

DocuSigned by:
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Jeffrey G. Angeja
Administrative Law Judge

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