OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18043005
S. ARNOLD	) CDTFA Case ID: 916746
	) CDTFA Acct. No. 053-013727
	)
	)

OPINION

Representing the Parties:

For Appellant:	Steven J. Duben, CPA
For Respondent:	Chad Bacchus, Tax Counsel III Stephen Smith, Tax Counsel IV
For Office of Tax Appeals:	William J. Stafford, Tax Counsel III

J. ANGEJA, Administrative Law Judge: Pursuant to California Revenue and Taxation Code (R&TC) section 6561, S. Arnold (appellant) appeals a decision issued by the California Department of Tax and Fee Administration (CDTFA)[1] denying appellant's petition for redetermination of a July 16, 2015 Notice of Determination (NOD). The NOD is for tax of $240,082.40, a negligence penalty of $24,008.28, and a finality penalty of $24,008.24, plus applicable interest, for the period of July 1, 2007, through June 30, 2010 (Audit Period).[2] The NOD reflects CDTFA's determination that appellant is personally liable for the unpaid sales and use tax liabilities of Legends Home Furnishings (Legends), a California corporation.

Office of Tax Appeals (OTA) Administrative Law Judges Linda C. Cheng, Richard I. Tay, and Jeffrey G. Angeja, held an oral hearing in this matter on August 21, 2019, in Los Angeles, California. At the conclusion of the hearing, the record was held open to allow

[1] Sales taxes were formerly administered by the State Board of Equalization (BOE). Effective July 1, 2017, functions of the BOE 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, BOE.

[2] As discussed further below, the NOD set forth an aggregate measure of $2,926,973. After the NOD was issued, CDTFA's appeals division issued a decision dated July 26, 2017, which reduced the aggregate measure to $2,869,177 and provided conditional relief of the finality penalty. Accordingly, the finality penalty is not at issue in this appeal. (CDTFA OB, Ex. 1, pp. 7 & 21.)

appellant time to provide evidence regarding the issue of whether reductions to the liability based on alleged non-sales deposits are warranted. The record closed effective December 18, 2019, and this matter was submitted for decision.

ISSUES

1. Whether appellant is personally liable as a responsible person for Legends' unpaid liabilities for the Audit Period.
2. Whether reductions to the liability assessed to Legends are warranted.
3. Whether the 10-percent negligence penalty imposed against legends was warranted.

FACTUAL FINDINGS

1. In October 1997 appellant incorporated Legends, a furniture retailer located in San Diego, California. Legends had two San Diego locations: (1) the main showroom (and warehouse) along Miramar Road, and (2) a secondary showroom along University Drive.
2. The parties stipulated that Legends ceased business operations on or about July 24, 2012.
3. The parties stipulated that Legends collected sales tax reimbursement on all of its retail sales of tangible personal property during the Audit Period.
4. The parties stipulated that appellant was Legends' president, chief financial officer, sole director, and sole shareholder throughout Legends' entire existence.
5. Appellant's health had been in decline since 2006. As a result, appellant worked a reduced workweek, which appellant describes as eight to twelve hours per week from 2006 through the close of business in 2012.
6. Appellant, as president of Legends, signed numerous documents on behalf of the company, such as lease agreements and sales tax returns. Moreover, appellant was the only person authorized to sign checks for the company.
7. Appellant reviewed Legends' business records, sales journals, and sales reports approximately three to four times per week.

Ms. M. Swearingen

8. Ms. M. Swearingen served as Legends' office manager throughout the Audit Period, and appellant was her supervisor.

9. As office manager, Ms. Swearingen handled bookkeeping for both store locations and prepared all checks to vendors for appellant to review and sign on the day(s) he came into the office each week.
10. Appellant monitored Legends' bank accounts, loaned Legends' money as needed, and transferred funds between Legends' accounts as needed to provide for payroll and expenses.
11. During the Audit Period, Legends paid wages and compensation to officers and employees in excess of $600,000, as well as rent in excess of $600,000, and purchases in excess of $700,000.

Sales Reports and Original Returns

12. Ms. Swearingen, the office manager, prepared sales reports during the Audit Period.
13. As president, appellant signed Legends' original sales and use tax returns for the fourth quarter of 2007 (4Q07), 1Q08–4Q08, 1Q09, 3Q09, 4Q09, 1Q10-2Q10.
14. Appellant, as president, also signed Legends' sales and use tax prepayment forms for February 2010; April 1, 2010, through June 15, 2010; July 2010, through August 2010; and October 2010.
15. Between September 27, 2010, through October 3, 2012, appellant signed five BOE-122 (*Waiver of Limitation)* forms[3] on behalf of Legends.

The Audit and Proposed Assessment

16. During the Audit Period, Legends had net bank deposits of $4,318,346, which exceeded its reported taxable sales of $1,449,169 by $2,869,177. Further, Legends' total sales as listed on its federal income tax returns exceeded its total sales as listed on its sales and use tax returns by $879,648.
17. CDTFA issued a timely NOD to Legends on November 8, 2012. The NOD set forth an aggregate measure of $2,926,973, which was based on the following two audit items: (1) unreported taxable sales of $2,047,325 based on a bank deposit analysis, and (2) unreported taxable sales of $879,648 based on an analysis of federal income tax returns. The NOD proposed a tax of $240,082.40 and a negligence penalty of $24,008.28, plus

[3] Form BOE-122 waives the applicable statute of limitations for a specified period, thereby extending the deadline by which CDTFA may timely issue an NOD. (See R&TC, § 6488.)

applicable interest. After Legends failed to timely petition or pay the NOD, the liability became final.

18. Because Legends did not timely pay the NOD by December 8, 2012—or otherwise enter into a timely payment plan with CDTFA—CDTFA imposed a finality penalty of $24,008.24.

19. CDTFA issued the above-referenced NOD to appellant, who timely filed a petition for redetermination, contesting the proposed tax liability, penalties, and applicable interest.

20. After a review of the audit findings, CDTFA issued a decision dated July 26, 2017, reducing the aggregate measure to $2,869,177, which amount was solely comprised of unreported taxable sales based on an analysis of bank deposits. In addition, CDTFA proposed to relieve the finality penalty, on the condition that appellant pay the liability, or otherwise enter into a timely payment plan with CDTFA, within 30 days of the mailing of a notice of final decision.

21. Appellant subsequently filed this timely appeal.

DISCUSSION

Issue 1 – Whether appellant is personally liable as a responsible person for Legends' unpaid liabilities for the Audit Period.

The law provides, in pertinent part, that any responsible person who willfully fails to pay or to cause to be paid the taxes due from a corporation shall be personally liable for unpaid taxes and interest and penalties not so paid upon termination of the business of the corporation. (R&TC, § 6829(a); Cal. Code Regs., tit. 18, § 1702.5(a).) Personal liability may only be imposed if CDTFA establishes that, while the person was a responsible person, the corporation collected sales tax reimbursement from customers (whether separately stated or included in the selling price) and failed to remit such tax when due. (R&TC, § 6829(c); Cal. Code Regs., tit. 18, § 1702.5(a).) In summary, there are four elements that must be met in order to impose responsible person liability: (1) that the corporation collected sales tax reimbursement (or incurred a use tax liability); (2) termination of the business; (3) that the person was responsible for the corporation's sales and use tax compliance during the liability period; and (4) the person willfully failed to pay or cause to be paid. CDTFA has the burden to prove these elements by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 1702.5(d).)

Elements 1 & 2

Here, the parties stipulated that Legends' business operations effectively terminated on or about July 24, 2012, and that Legends collected sales tax reimbursement on its retail sales of tangible personal property during the Audit Period. Notwithstanding the concession regarding the collection of sales tax reimbursement, in his post-hearing brief appellant contends that CDTFA has not proven that sales tax reimbursement was collected on the additional gross receipts based on the bank deposits analysis. We reject appellant's contention for several reasons. First, appellant's argument in his brief exceeds the limited scope of post-hearing additional briefing that we stated in our August 22, 2019 Order, and for that reason alone, appellant's contention must be disregarded.[4] Second, appellant has not established good cause to withdraw from its stipulation (see *Appeal of Praxair, Inc.*, 2019-OTA-301P), which also compels the rejection of this contention. Third, the evidence in the hearing record (i.e., CDTFA's Exhibit B) consists of several statements from employees as well as appellant himself indicating that Legends collected sales tax reimbursement in connection with its taxable retail sales, and appellant has provided no evidence to the contrary. Therefore, consistent with appellant's stipulation, we conclude that CDTFA has established by a preponderance of the evidence that Legends' collected sales tax reimbursement in connection with all of its taxable retail sales.

Element 3 – Responsible Person

Personal liability can be imposed only on a responsible person. (R&TC, § 6829(b).) In this context, "responsible person" means any person having control or supervision of, or who was charged with the responsibility for, the filing of returns or the payment of tax or who had a duty to act for the corporation in complying with any portion of the Sales and Use Tax Law when the taxes became due. (Cal. Code Regs., tit 18, § 1702.5(b)(1).) As relevant here, personal liability applies only if, when the person was a responsible person for the corporation, the corporation sold tangible personal property and collected sales tax reimbursement on the selling price of the property and failed to remit such tax reimbursement when due. (Cal. Code Regs.,

[4] Our order expressly described the scope of additional briefing: "**Scope of Briefing:** The above-referenced panel requests appellant to file a post-hearing brief and/or evidence regarding the following alleged deposits during the Audit Period: (1) $5,000 a month in rental income; (2) $2,500 a month in storage fees; (3) $7,000 a month in nontaxable furniture delivery fees; and (4) $10,000 a month in reimbursements from furniture manufactures for raw materials purchased by Legends on their behalf."

tit. 18, § 1702.5(a).) Simply because a person was an officer, member, manager, employee, director, shareholder or partner of a business is not, in and of itself, sufficient proof to establish that the person is a "responsible person." (Cal. Code Regs., tit. 18, § 1702.5(b)(1).) A chief executive officer, however, is presumed to have broad implied and actual authority to do all acts customarily connected with the business, including ensuring its compliance with the Sales and Use Tax Law, even if that responsibility is delegated to others. (See *Commercial Sec. Co. v Modesto Drug Co*. (1919) 43 Cal.App.162, 173.) More than one person may be held liable under R&TC section 6829 for the same primary liability, as long as the requirements for imposing such liability on each person are satisfied. (See R&TC, § 6829.)

On appeal, appellant argues that he is not a responsible person because he did not have direct hands-on involvement with Legends' day-to-day business matters. Appellant explains that his health has been in decline since 2006 and, as a result, he relied upon his managers to run the business, which included the payment and accounting for sales tax.

Here, the evidence in the appeal record demonstrates that despite appellant's decline in health since 2006 and his use of managers to run the business, appellant had significant involvement with Legends' sales and use tax compliance matters during the entire Audit Period. Specifically, appellant, as president, signed Legends' original sales and use tax returns for 4Q07, 1Q08–4Q08, 1Q09, 3Q09, 4Q09, 1Q10-2Q10. In addition, appellant, as president, signed Legends' sales and use tax prepayment forms for February 2010; April 1, 2010, through June 15, 2010; July 2010, through August 2010; and October 2010. Appellant also signed five *Waiver of Limitation* forms on behalf of Legends, that extended the deadline by which CDTFA could timely issue an NOD to Legends. Appellant clearly had responsibility for Legend's sales and use tax compliance in order to have executed these sales and use tax documents.

Also, we note that appellant was Legends' president, chief financial officer, sole director, and sole shareholder throughout Legends' entire existence. The president of a corporation is the general manager and chief executive officer of the corporation, unless otherwise provided in the articles or bylaws. (Corp. Code, § 312(a).) A general manager is presumed to have broad implied and actual authority to do all acts customarily connected with the business, including ensuring its compliance with the Sales and Use Tax laws, even if that responsibility is delegated to others. (*See Commercial Sec. Co. v Modesto Drug Co.* (1919) 43 Cal.App. 162, 173.) Here, appellant has not alleged or established that his duties as president did not include responsibility

for Legends' sales and use tax compliance, and accordingly we find that he had the responsibility to ensure Legends' sales and use tax compliance. Based on all of the foregoing, we find that appellant was responsible for Legends' tax compliance during the entire Audit Period and when the liabilities at issue became due.

Element 4 – Willful

Finally, the term "willfully fails to pay or to cause to be paid" means that the failure was the result of a voluntary, conscious and intentional course of action. (Cal. Code Regs., tit. 18, § 1702.5(b)(2).) A failure to pay or to cause to be paid may be willful even though such failure was not done with a bad purpose or motive. (*Ibid*.) In order to show willfulness, CDTFA must establish all of the following:

> (A) On or after the date that the taxes came due, the responsible person had actual knowledge that the taxes were due, but not being paid.
>
> (B) The responsible person had the authority to pay the taxes or to cause them to be paid (i) on the date that the taxes came due and (ii) when the responsible person had actual knowledge as defined in (A). A responsible person who was required to obtain approval from another person prior to paying the taxes at issue and was unable to act on his or her own in making the decision to pay the taxes does not have the authority to pay the taxes or to cause them to be paid.
>
> (C) When the responsible person had actual knowledge as defined in (A), the responsible person had the ability to pay the taxes but chose not to do so.

(Cal. Code Regs., tit. 18, § 1702.5(b)(2).)

Knowledge

Here, the audit was determined using a bank deposits analysis, and the evidence shows that appellant reviewed Legends' bank statements, financial statements, and sales reports, which indicates that appellant knew what funds were deposited into Legends' bank accounts. The evidence also establishes that appellant was aware of the taxable sales Legends reported on its sales and use tax returns, because he reviewed and filed them during the Audit Period. Based on the foregoing, we find that appellant had actual knowledge of the discrepancy between the gross receipts reported on Legends' sales and use tax returns and the gross receipts deposited into Legends' bank accounts.

In his post-hearing brief, appellant asserts that although he knew of the discrepancy between bank deposits and reported taxable sales, he had no reason to know of the unreported tax liability. Specifically, appellant argues that the liability, which is based on a bank deposits analysis, results in an excessive markup. Further, appellant asserts he expected to see differences between Legends' bank deposits and Legends' reported taxable sales, based on alleged non-sales deposits. As a result, appellant asserts that CDTFA has failed to establish that he had actual knowledge that Legends' underreported its taxable sales.

We find appellant's arguments to be unpersuasive. First, the arguments exceed the limited scope of the post-hearing briefing that we ordered, and must be rejected on that basis.[5] Second, Legends' bank deposits of $4,318,346 exceeded its reported taxable sales of $1,449,169 by $2,869,177 during the Audit Period, which equates to an error ratio of 201.9 percent ([$2,926,973 x 100] ÷ $1,449,169 = 201.9%). On appeal and during the hearing, appellant argued that the taxable measure should be reduced by $882,000[6] for alleged non-sales deposits – which still leaves a huge, unexplained discrepancy of $1,987,177. Absent evidence sufficient to explain such a large difference between Legends' bank deposits and its reported taxable sales, of which appellant has provided none, we conclude that the preponderance of the evidence establishes that appellant knew that Legends' tax liabilities were not being paid.

Authority

The second requirement is that the responsible person had authority to pay the taxes or to cause them to be paid (i) on the date that the taxes came due, and (ii) when the responsible person had actual knowledge. (Cal. Code Regs., tit. 18, § 1702.5(b)(2)(B).) Appellant contends that he did not have authority to pay the tax deficiency disclosed by CDTFA's audit on the date the NOD was issued to Legends (on November 8, 2012), as Legends terminated its business operations on or about July 24, 2012, and executed an assignment for the benefit of creditors to the San Diego Credit Association on July 24, 2012.

[5] We also note that the audit determination was made using a bank deposits analysis, not a markup analysis. Accordingly, assertions that the markup is excessive are insufficient to establish that the resulting liability is overstated.

[6] According to appellant, because that amount represents income Legends derived from the following: (1) $5,000 a month in rental income; (2) $2,500 a month in storage fees; (3) $7,000 a month in nontaxable furniture delivery fees; and (4) $10,000 a month in reimbursements from furniture manufactures for raw materials purchased by Legends on their behalf. To date, appellant has failed to submit evidence substantiating these amounts of alleged non-sales deposits.

Appellant's contention is misplaced, because the relevant date on which the taxes became due is the last day of the month following each quarter of the Audit Period – prior to the assignment on July 24, 2012. At each of those times, appellant had the authority to pay Legends' taxes or cause them to be paid, as shown by the fact that appellant signed and filed Legends' sales and use tax returns during the liability period, and was the only person authorized to sign checks for the company. Further, as noted above, appellant was Legends' president, chief financial officer, sole director, and sole shareholder throughout Legends' entire existence. As such, appellant had the authority pay or cause Legends' tax liabilities to be paid, when the taxes became due.

Ability to Pay

The third requirement is that when the responsible person had actual knowledge, the responsible person had the ability to pay the taxes but chose not to do so. (Cal. Code Regs., tit. 18, § 1702.5(b)(2)(C).) Appellant contends that Legends had timely filed and paid all taxes shown on its sales and use tax returns. Further, appellant contends that the tax liability proposed in the NOD was not determined until after Legends had entered into an assignment with the San Diego Credit Association, as assignee, on July 24, 2012, and therefore, appellant did not have the ability to pay when the NOD was issued.

Here, it is undisputed that Legends collected sales tax reimbursement from its customers on its retail sales of tangible personal property during the Audit Period, and thus Legends had those funds available with which to pay its tax liability as the taxes were collected. In addition, during the Audit Period, Legends paid wages and compensation to officers and employees in excess of $600,000, as well as rent in excess of $600,000, and purchases in excess of $700,000. Accordingly, we find that appellant had knowledge of the unpaid liabilities during the Audit Period and had the ability to pay them, but elected not to. Therefore, we conclude that appellant is personally responsible for Legends' unpaid tax liabilities within the meaning of R&TC section 6829.

Issue 2 – Whether reductions to the liability assessed to Legends are 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.)

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 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 (*Riley B's*).) 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, for the Audit Period, CDTFA found that Legend's had net bank deposits of $4,318,348 that exceeded Legends' reported taxable sales of $1,449,169 by $2,869,177. Based on the foregoing, CDTFA determined that Legends had underreported its taxable sales for the Audit Period by $2,869,177, which equates to an error ratio of 201.9 percent ([$2,926,973 x 100] ÷ $1,449,169 = 201.9%). CDTFA's determination is based on Legends' own business records and bank deposits, which is reasonable and rational. Accordingly, we find that CDTFA has established that its determination is reasonable and rational, and the burden shifts to appellant to establish that a result differing from CDTFA's determination is warranted.

On appeal, appellant contends that the taxable measure should be reduced by $882,000, because that amount represents income Legends derived from the following: (1) $5,000 a month in rental income; (2) $2,500 a month in storage fees; (3) $7,000 a month in nontaxable furniture delivery fees; and (4) $10,000 a month in reimbursements from furniture manufacturers for raw materials purchased by Legends on their behalf.

Again, CDTFA's use of Legends' business records and bank deposits to establish Legends' underreported taxable sales is a reasonable method of estimating taxable sales. (See *Riley B's, supra*.) Here, appellant has not provided specific evidence substantiating the nontaxable sales he is alleging (as set forth above) or otherwise demonstrating that the proposed

tax liability is erroneous. After the hearing, we allowed appellant the opportunity to substantiate the four foregoing alleged non-sales deposits, but appellant failed to provide any such evidence. Accordingly, we have no basis on which to recommend any reductions to the measure of tax.

Issue 3 – Whether the 10-percent negligence penalty imposed against Legends was warranted.

If any part of a deficiency is due to negligence, CDTFA shall add a 10-percent negligence penalty to the deficiency determination. (R&TC, § 6484.) Negligence is generally defined as a failure to exercise such care that a reasonable and prudent person would exercise under similar circumstances. (*Warner v. Santa Catalina Island Co*. (1955) 44 Cal.2d 310, 317.)

CDTFA included a 10-percent negligence penalty of $24,008.28 in the NOD issued to Legends on November 8, 2012, on the basis that Legends did not make a conscientious effort to properly report its taxable sales.

This was Legends' first audit. CDTFA states, however, appellant controlled a different business entity that was previously subject to audit, and that CDTFA's audit of the other business entity found evidence of unreported taxable sales, which resulted in a substantial understatement.

Appellant contends that the negligence penalty should be removed because Legends had timely filed all required returns and timely paid taxes for the Audit Period, and therefore, the company had not failed to take any action. In addition, appellant asserts that the tax liability assessed in the NOD was not assessed until after Legends had entered into an assignment for the benefit of the San Diego Credit Association. Appellant also contends that CDTFA's prior audit of the other business entity controlled by appellant was not similar to the current audit of Legends, as the prior audit of the other business entity was for the entity's failure to charge sales tax on delivery services. Further, appellant asserts that the prior audit of the other business entity was conducted approximately 20 years prior to the audit of Legends.

As indicated above, CDTFA determined that Legends underreported its taxable sales for the Audit Period by $2,869,177, which equates to an error ratio of 201.9 percent. Those amounts are strong indications of negligence. Further, as discussed above, Legends' own records establish a discrepancy between its gross receipts deposited into its bank accounts and its reported taxable sales, which indicates a standard of care well below that of a reasonably prudent business person. Accordingly, we conclude that the negligence penalty was properly imposed against Legends and that appellant is liable for that penalty as a responsible person.

HOLDINGS

1. Appellant is personally liable as a responsible person for Legends' unpaid tax liabilities.
2. No reductions to the liability assessed to Legends are warranted.
3. The negligence penalty imposed against Legends was warranted.

DISPOSITION

CDTFA's action in reducing the aggregate measure of tax to $2,869,177, and in relieving the finality penalty, on the condition that appellant pay the liability, or otherwise enter into a timely payment plan with CDTFA, within 30 days of the mailing of a notice of final decision in this matter, but otherwise denying appellant's petition, is sustained.

DocuSigned by:
Jeff Angeja
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Jeffrey G. Angeja
Administrative Law Judge

We concur:

DocuSigned by:
Linda C. Cheng
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Linda C. Cheng
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Date Issued: 3/6/2020