

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:

RICARDO'S ON THE BEACH, INC.

) OTA Case No. 18063296
) CDTFA Account No. 097-309611
) CDTFA Case ID 762694
)
)
)

OPINION

Representing the Parties:

For Appellant:

Gary Slavett, Attorney

For Respondent:

Sunny Paley, Tax Counsel
Monica Silva, Tax Counsel IV
Lisa Renati, Hearing Representative

For Office of Tax Appeals:

Philip Wahlquist, Graduate Student
Assistant

S. BROWN, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Ricardo’s on the Beach, Inc., doing business as Dinah’s Family Restaurant, (appellant) appeals a decision issued by the California Department of Tax and Fee Administration (CDTFA)¹ on appellant’s timely petition for redetermination of a Notice of Determination (NOD) proposing \$1,465,030.30 of additional tax, a 25-percent penalty of \$366,257.79 for fraud or intent to evade the payment of tax, and applicable interest for the period January 1, 2005, through December 31, 2011.²

¹ Prior to July 1, 2017, CDTFA’s sales and use tax functions were administered by the State Board of Equalization (SBE). (See Gov. Code, §15570.22.) Therefore, for ease of reference, when this opinion refers to acts or events that occurred prior to July 1, 2017, “CDTFA” shall refer to SBE.

² Appellant does not dispute the amount of the deficiency in tax. Appellant only disputes the applicability of the penalty and timeliness of the NOD. Therefore, this opinion will only address the fraud penalty and the statute of limitations.

Office of Tax Appeals Administrative Law Judges Suzanne B. Brown, Michael F. Geary, 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 CDTFA has established by clear and convincing evidence that the 25-percent fraud penalty under R&TC section 6485 is applicable for the period January 1, 2005, through December 31, 2011.
2. Whether the NOD was timely issued pursuant to R&TC section 6487(a) for the period January 1, 2005, through September 30, 2008.

FACTUAL FINDINGS

1. Appellant, a corporation, has operated two restaurants in California since June 1, 1998: Dinah's Family Restaurant, located in Culver City, and Ricardo's El Ranchito, located in La Habra. Appellant's corporate officers and owners are M. Ernst and T. Ernst, who are husband and wife.
2. For the period January 1, 2005, through December 31, 2011 (the liability period), appellant reported total taxable sales of \$15,858,763, claiming no deductions.
3. CDTFA initially commenced the audit of appellant for the period October 1, 2008, through December 31, 2011. During the course of the audit, the Ernsts signed waivers extending until October 31, 2013, the statute of limitations for the tax periods between October 1, 2008, and June 30, 2010.
4. X. Velazco was appellant's accountant³ who represented appellant during the liability period and the beginning of CDTFA's audit of appellant.
5. Mr. Velazco was involved in preparing the books and records that were used to prepare appellant's sales and use tax returns. Mr. Velazco also provided to CDTFA the information at audit which included: (1) federal income tax returns (FITRs) for taxable years 2008 through 2011, (2) annual profit and loss statements from 2009 through 2011,

³ According to testimony from Mr. Ernst, previously Mr. Velazco was an employee of TLD Acquisition Co., LLC, which is owned in part by Mr. Ernst, but Mr. Velazco left that employment in 2010 or 2011 to open his own accounting practice, and thereafter appellant was a client of Mr. Velazco's.

- (3) monthly sales summaries, bank statements, and credit card merchant statements for October 1, 2008, through December 31, 2011, and (4) merchandise purchase invoices for some days in the period October 1, 2008, through December 31, 2011.
6. Appellant did not provide any cash register Z-tapes⁴ from the liability period, but did provide computerized point of sale (POS) reports for February 2012 through June 2012, at CDTFA's request. POS verification for that time period indicated that sales tax reimbursement was correctly added to the customers' checks.
 7. During audit, CDTFA compared gross receipts reported on the 2008 through 2011 FITRs provided at audit to total sales reported on the sales and use tax returns and found no material differences for these years. However, upon CDTFA's comparison of sales deposits (bank deposits less non-sales related deposits or credits) to total sales reported on the sales and use tax returns, CDTFA found that sales deposits for the period October 1, 2008, through December 31, 2011, exceeded reported total sales for the same period by \$9,123,674 (\$15,470,474 - \$6,346,800).
 8. CDTFA considered the large amount of unexplained excess sales deposits to be potential evidence of fraud. Thus, CDTFA obtained from the Franchise Tax Board (FTB) appellant's FITRs filed with the Internal Revenue Service (IRS) going back to 2005.
 9. Upon reviewing those FITRs, CDTFA identified substantial discrepancies between the amounts listed on the FITRs that had been filed with the IRS and the copies of FITRs provided by appellant at audit. In light of those discrepancies, and due to the large amount of unexplained excess sales deposits, CDTFA concluded that appellant provided falsified books and records to the auditor. As a result, CDTFA expanded the period under audit to January 1, 2005, through December 31, 2011.
 10. Comparing appellant's gross receipts as stated on the FITRs obtained from FTB to appellant's reported taxable sales, CDTFA calculated unreported taxable sales of \$1,883,084 for 2005, \$2,091,828 for 2006, \$2,345,677 for 2007, \$2,622,884 for 2008, \$2,445,149 for 2009, \$2,706,708 for 2010, and \$2,836,364 for 2011. Thus, the total unreported taxable sales during the liability period amounted to \$16,931,694.

⁴ Such cash register tapes are summaries of transactions and are known as "Z-tapes." (See, e.g., CDTFA Business Tax and Fee Division Audit Manual § 0802.40.)

11. After CDTFA notified appellant that it had discovered that the FITRs appellant provided at audit were falsified, Mr. Velazco was no longer involved with the audit, and appellant notified CDTFA that it would be represented at the audit by Samuel Biggs, CPA. Thereafter, CDTFA discussed the audit findings with Mr. Ernst and Mr. Biggs, who agreed that the FITRs the auditor had obtained from FTB were accurate.
12. In a memorandum dated July 17, 2013, CDTFA recommended imposing a 25-percent fraud penalty as provided by R&TC section 6485. In support, CDTFA stated that appellant consistently and grossly underreported its taxable sales throughout the liability period representing an error ratio of 106.77 percent when unreported taxable sales were compared to taxable sales. Further, CDTFA found that appellant had provided falsified books and records for audit, and noted that appellant had conceded during the audit exit interview that the FITRs obtained from FTB were accurate. CDTFA concluded that the Ernsts were actively involved in the daily operations of the business and that Mr. Ernst had knowledge of the Sales and Use Tax Law as evidenced by his prior business experience as the owner, officer, or partner in other businesses with seller's permits in California. CDTFA concluded that the magnitude and the consistency of the underreporting could not be attributed to honest mistakes or mere negligence.

DISCUSSION

Issue 1 - Whether CDTFA has established by clear and convincing evidence that the 25-percent fraud penalty under R&TC section 6485 is applicable for the period January 1, 2005, through December 31, 2011.

In the case of a deficiency determination, a penalty of 25 percent of the amount of the determination applies if any part of the deficiency is due to fraud or an intent to evade the law or any authorized rules or regulations. (R&TC, § 6485.) Fraud or intent to evade is never presumed, but must be proven, and the burden of proof is on respondent by clear and convincing evidence. (Cal. Code Regs, tit. 18, § 1703(c)(3)(C); see, e.g., *In re Renovizor's Inc.* (9th Cir. 2002) 282 F.3d 1233, 1241). The express language of R&TC section 6485 makes it clear that a fraud penalty shall be imposed on the entire deficiency "if any part" of that deficiency determination is due to fraud. Fraud can be proved by circumstantial evidence. (*Bradford v. Commissioner* (9th Cir. 1986) 796 F.2d 303, 307.) The badges of fraud may include the

understatement of income, inadequate records, failure to file tax returns, implausible or inconsistent explanations of behavior, concealment of assets, failure to cooperate with tax authorities, and lack of credibility in the taxpayer's testimony. (*Ibid.*) Federal courts have also concluded that the mere omission of reportable income is not of itself sufficient to warrant a finding of fraud, but repeated understatements in successive years, combined with other circumstances showing intent to conceal or misstate taxable income, present a sufficient basis for a finding of fraud. (*Rau's Estate v. Commissioner* (9th Cir. 1962) 301 F.2d 51, 54-55.)

During the liability period, appellant failed to report \$16,931,694 of taxable sales, and only reported sales of \$15,858,763, which means that appellant only reported approximately 48 percent of its sales during the seven-year liability period at issue. Moreover, upon audit appellant's representative provided falsified FITRs, and books and records. While fraud may not be presumed from a mere understatement of tax, appellant's pattern of consistent and substantial underreporting over a number of years, in addition to the provision of falsified returns, are sufficient to establish fraud. (See *Bradford v. Commissioner, supra*, 796 F.2d at 307.)

Appellant does not dispute that fraud occurred, but argues that its former accountant, Mr. Velazco, engaged in fraud without appellant's knowledge or consent, and thus Mr. Velazco's fraudulent acts may not be imputed to appellant. Here, there is nothing in the record that indicates that appellant's corporate principals, the Ernsts, authorized anyone to commit fraud. The more difficult question is whether at some point during the liability period the corporate principals must have known of the fraud. However, at this time we need not reach that question because we first address whether the fraud penalty applies even if they never knew of the fraud. Given the dearth of relevant case law as it applies to R&TC section 6485, we consider by analogy the standards that apply under Internal Revenue Code section 6663, the federal income tax fraud penalty. Under that standard, the relevant question here is whether appellant's agent was acting on behalf of and not against the corporation with the result that the corporation benefited from the agent's fraudulent acts. (*Ruidoso Racing Ass'n, Inc. v. Commissioner* (10th Cir. 1973) 476 F.2d 502, 506; *Alexander Shokai, Inc. v. Commissioner*. (9th Cir. 1994) 34 F.3d 1480, 1488.) If so, the fraud of the agent may be imputed to the corporation. (*Ibid.*)

The evidence shows that appellant received a direct benefit from the fraudulent activities due to the collected sales tax reimbursement that was not remitted to CDTFA and was instead deposited directly into appellant's bank account. Although appellant alleges that it was

defrauded by Mr. Velazco, appellant has failed to provide specific evidence to support this contention. Appellant did not file a police report or bring legal action against Mr. Velazco, and appellant's bank deposits and other financial records do not reflect any embezzlement of funds or fraud suffered by appellant. Appellant simply alleges that most likely Mr. Velazco must have embezzled funds or otherwise defrauded appellant, but acknowledges that it is unable to show that this occurred. Unsupported contentions are insufficient to establish that appellant was defrauded. Hence, the evidence supports a conclusion that appellant benefited from the fraudulent acts, and the evidence fails to establish that Mr. Velazco defrauded appellant. Accordingly, the fraud penalty is appropriately imputed to appellant.

Based on the facts and circumstances, we conclude that CDTFA has established fraud for the audit period by clear and convincing evidence.

Issue 2 - Whether the NOD was timely issued pursuant to R&TC section 6487(a) for the period January 1, 2005, through September 30, 2008.

As relevant here, R&TC section 6487(a), provides that except in the case of fraud or intent to evade, every NOD shall be mailed within three years. In this case, because CDTFA has established fraud by clear and convincing evidence, the NOD was timely issued for the period January 1, 2005, through September 30, 2008.⁵

⁵ Because the Ernsts signed waivers extending until October 31, 2013, there is no dispute that the NOD was timely issued within the statute of limitations for the tax period October 1, 2008, through June 30, 2010.

HOLDINGS

1. CDTFA has established by clear and convincing evidence that the 25-percent fraud penalty under R&TC section 6485 is applicable for the liability period.
2. The NOD was timely issued within the statute of limitations for the period January 1, 2005, through September 30, 2008.

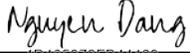
DISPOSITION

CDTFA’s decision is sustained.

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 Suzanne B. Brown
 Administrative Law Judge

We concur:

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 Nguyen Dang
 Administrative Law Judge

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 Michael F. Geary
 Administrative Law Judge

Date Issued: 3/6/2020