OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 19125640
	) CDTFA Case ID: 595305
Z. ANDESHA, Z. RASHID, and R. RASHID, dba Salang Pass Restaurant	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Mitchell Stradford, Representative
For Respondent:	Jason Parker, Chief of Headquarters Operations
For Office of Tax Appeals:	Deborah Cumins, Business Taxes Specialist III

J. ALDRICH, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, the partnership of Z. Andesha, Z. Rashid, and R. Rashid (appellant)[1] appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[2] in response to appellant's timely petition for redetermination of the Notice of Determination (NOD) dated October 14, 2011. The NOD is for tax of $199,606.51, applicable interest, and a fraud penalty of $49,901.84 for the period July 1, 2006, through December 31, 2010 (audit period). In its subsequent decision, CDTFA reduced the understated measure of tax from $2,193,742 to $1,883,261, which resulted in a reduction to the tax and penalty, and otherwise denied the appeal.

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

[1] A partnership is a person for sales and use tax purposes. (R&TC, § 6005.)

[2] Sales taxes were formerly administered by the 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 this Opinion refers to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to its predecessor, the board.

ISSUE

Whether the fraud penalty is supported by clear and convincing evidence.

FACTUAL FINDINGS

1. Appellant operated an Afghani restaurant in Fremont from July 1, 2006, through December 31, 2018. The restaurant made sales of hot prepared food products for consumption at tables and chairs provided by appellant and sales of hot food to customers off-site.[3] Appellant added sales tax reimbursement to its selling prices in the restaurant.[4]
2. The restaurant was previously operated as a partnership from January 1, 2004, through June 30, 2006, and one of the prior partners was Z. Andesha. On June 30, 2006, the seller's permit for the previous partnership was closed and Z. Andesha opened another seller's permit with two other partners, Z. Rashid and R. Rashid.
3. During the audit period, appellant reported total sales of $1,164,737 and claimed deductions of $316,609 for nontaxable sales of food, $44,185 for sales tax reimbursement included in reported total sales, and $3,720 labeled as "other." After claimed deductions, appellant reported taxable sales of $800,223.
4. For audit, appellant provided federal income tax returns for 2007 and 2009, sales and use tax returns and related worksheets, cash register z-tapes,[5] point-of-sale (POS) summary reports, and some bank statements. Although CDTFA requested that appellant provide monthly sales journals, appellant stated that the sales journals could not be reprinted from the POS system.
5. CDTFA found that the credit card deposits for the bank statements for the years 2009 and 2010 totaled $1,157,669, which substantially exceeded appellant's reported total sales of $697,424 for the same period.

[3] It is unknown whether appellant made sales of hot food to go or if it delivered the hot food to customers. However, appellant provided invoices and contracts after the appeals conference that represented sales to customers such as the Marriott Hotel. In a November 12, 2014 letter to appellant, CDTFA explained that it had contacted the customers, who said that the food purchased from appellant had been hot prepared food products.

[4] It is not clear from the record whether appellant added sales tax reimbursement to its sales of hot food to customers off-site.

[5] A cash register z-tape is the portion of the cash register tape that summarizes sales by category for a certain period (i.e., a day or a shift).

6. CDTFA concluded that further investigation was warranted and decided to establish audited taxable sales using the credit card ratio audit method.

7. CDTFA conducted a one-day observation test and computed a ratio of tips to credit card sales of 7.53 percent and a ratio of credit card sales to total sales (credit card ratio) of 81.68 percent. It then reviewed the cash register z-tapes for the first quarter 2009 (1Q09) and computed a credit card ratio of 78.30 percent. CDTFA combined the observation test with the recorded information for 1Q09 to compute a credit card ratio of 78.34 percent. CDTFA used known credit card receipts (from bank statements) and the credit card ratio of 78.34 percent to compute audited taxable sales for the years 2009 and 2010. For periods before 2009, appellant did not provide bank statements. Accordingly, CDTFA used the information for the years 2009 and 2010 to compute a percentage of error of 300.71 percent. To compute the percentage of error, CDTFA excluded 3Q09 and 4Q10 because appellant had reported higher amounts of taxable sales for those quarters and CDTFA apparently found the reported amounts to be aberrations. CDTFA computed an understatement of reported taxable sales of $2,193,742.

8. CDTFA's September 15, 2011, Memorandum concluded that the factors clearly demonstrate appellant's intent to evade or underreport the payment of the sales tax due, according to the following:

    a. According to the "*History of the Business Operations*," the business was operated by Z. Andesha and A. Andesha from January 1, 2004, to June 30, 2006. That partnership's seller's permit was closed and Z. Andesha opened a new permit with R. Rashid as her partner as of July 1, 2006.[6] The operation of the restaurant stayed the same before and after the change of the business entity (e.g., open 7 days per week and seating capacity for approximately 72 customers). The books and records summarizing restaurant sales were severely limited for the entire audit period.

    b. In the section "*Evidence of Knowledge of the Requirements of the Law*," CDTFA asserted that appellant demonstrated an adequate knowledge of the Sales and Use Tax Law as documented by:

[6] It is unclear why CDTFA's September 15, 2011, Memorandum does not refer to both new partners, R. Rashid and Z. Rashid.

i. Taxpayer Z. Andesha has seven years of experience in operating the business which should provide her an actual and constructive knowledge as to the requirements of the law by maintaining an active seller's permit and properly computing and collecting sales tax reimbursement.

ii. Most of the sales made by the restaurant were of hot food products for consumption from tables and chairs provided in the premises. All sales were taxable under California Code of Regulations, title 18, section 1603(c) or the "80/80 rule."

iii. The taxpayer added sales tax reimbursement to the selling price of all food consumed in the restaurant. The collection of sales tax reimbursement on taxable sales was documented in an undercover purchase and observation guest receipt.

c. In the section "*Intent to Evade,*" CDTFA asserted the following:

i. The taxpayer provided their accountant the amounts of taxable sales to be reported to CDTFA. The accountant reported the numbers furnished by taxpayer as taxable measures for sales tax reporting purposes.

ii. Credit card deposits vs. total reported sales: The sum of credit card bank deposits of $1,157,669 were determined to materially exceed the reported total sales of $697,424 for the period of January 2009 to December 2010 during the audit period. The understatement based on credit card deposits only is $460,245 or 65.99 percent of the reported total amount.

iii. Reported taxable sales vs. audited taxable sales: The taxpayer reported taxable measure for the period of January 2009 to December 2010 during the audit period is $364,140 as compared to the audited taxable sales of $882,406. Based on the audited taxable sales, the understatement is 242.33 percent of the reported taxable sales.

iv. Reported taxable measure (per quarter) vs. audited taxable measure: The taxpayer reported an average of $45,518 taxable measure per quarter for the audit period from 1Q09 to 4Q10 whereas audited taxable sales per quarter during the audit period was determined to be $110,301 ($882,406/8).

v. Although CDTFA does not have bank statements prior to January 1, 2009, reported taxable sales for the period July 1, 2006, through December 31, 2008, are similar to the period January 1, 2009, through December 31, 2010. Salang Pass Restaurant reported $476,337 in taxable sales for 10 quarters prior to January 1, 2009, an average of $47,633 per quarter.

9. On October 14, 2011, CDTFA issued the NOD for tax of $199,606.51 and a fraud penalty of $49,901.84.

10. On November 14, 2011, appellant filed a petition for redetermination.

11. On May 25, 2012, CDTFA prepared a reaudit that reduced the understatement of reported taxable sales to $1,939,137, reduced the determined tax to $177,329.44, and reduced the fraud penalty to $44,332.55. During the reaudit, CDTFA concluded it was not appropriate to exclude 3Q09 and 4Q10 from its computation. Therefore, CDTFA included the amounts for those quarters and recomputed an error rate of 242.33 percent, which it used to recompute the understatement for periods before 2009.

12. On July 24, 2013, CDTFA held an appeals conference. On February 28, 2014, CDTFA issued a Decision and Recommendation, recommending a reaudit to address new evidence provided by appellant to show that some of its sales were nontaxable sales of cold food products.

13. In a letter dated November 12, 2014, CDTFA declined to conduct a reaudit based on the new evidence appellant had provided. CDTFA explained that the new evidence that appellant presented did not support its assertion that it made bulk sales of nontaxable food products of significant amounts. Appellant had argued that an adjustment was warranted for nontaxable sales of cold food products and had provided invoices and contracts to support that argument. CDTFA found that no adjustments were warranted because when CDTFA contacted the customers, the customers indicated that they had only purchased hot prepared food products from appellant.

14. In appellant's Request for Reconsideration (RFR) dated October 1, 2018, appellant specifically conceded the audited understatement of reported taxable sales provided the recommended adjustments to the computation of the tip percentage were made. Appellant stated, "In support of the reporting practices of the taxpayer, we were able to

locate nine months of worksheets that appear to have been used to prepare the sales tax returns and have reconciled the recorded taxable and nontaxable sales with the amounts reported." The worksheets were attached at Exhibit 1 of the RFR.

15. On October 19, 2018, CDTFA completed a second reaudit to correct a computation error in the first reaudit. The revision increased the percentage of tips included in credit card sales from 7.53 percent to 9.42 percent. In the second reaudit, the understatement of reported taxable sales was decreased to $1,883,261.[7]

16. CDTFA responded to the RFR by memorandum on October 30, 2018. CDTFA indicated that it concluded that the numbers in appellant's Exhibit 1 of its RFR were not accepted or verified due to a lack of source documents. Specifically, CDTFA noted that no contracts or paperwork were provided regarding the hall rental for the entire audit period. Also, CDTFA indicated that during the December 7, 2010, site test, CDTFA was informed by the restaurant's manager that there was no hall rental involved during the audit period. Next, CDTFA noted that appellant claimed exempt sales of cold food (e.g., specialty yogurt, ice cream, bread, and rice). CDTFA contacted appellant's customers, as identified on the invoices provided, and confirmed that the invoices were for hot prepared food, which is taxable.[8] CDTFA also noted that appellant used a POS system throughout the audit period. CDTFA reported that it had requested actual POS reports or register z-tapes numerous times in order reconcile the worksheets, but appellant never provided those documents.

17. CDTFA issued a November 30, 2018, Memorandum that incorporated the October 30, 2018, Memorandum and the September 15, 2011, Memorandum. CDTFA concluded that the worksheets appellant provided with the RFR could not be relied upon as support for adjustments without source documents to support the worksheets. In addition, the November 30, 2018, Memorandum clarified that the collection of sales tax

[7] The second reaudit is not in the written record. However, the second reaudit is described in the Supplemental Decision, which is part of the written record.

[8] CDTFA also raised a question about whether the tips recorded on appellant's worksheet (all of which were exactly 20 percent) may have been mandatory or pre-negotiated tips, which would be includable in taxable gross receipts under California Code of Regulations, title 18, section 1603(g)(2). However, that particular issue is not directly relevant to the question of whether appellant had adequately supported its argument that an adjustment should be made for claimed exempt bulk sales of cold food, and we will not address it further.

reimbursement was documented in an undercover purchase on August 6, 2010, and during the site test on December 7, 2010.

18. On December 17, 2018, appellant responded by letter. Therein, appellant indicated that "There is no dispute that the worksheets contain errors and cannot be supported by additional documentation to verify the amounts or validity of the recorded nontaxable sales. The purpose of the worksheets is to demonstrate that the taxpayer made an effort to record and report its sales accurately. Because of negligence and a general lack of understanding of how to record and report taxable sales, the recorded nontaxable sales were essentially claimed twice which resulted in a substantial understatement. The worksheets were provided to give a reasonable explanation as to why the underreporting occurred."

19. CDTFA responded to the December 17, 2018, letter by memorandum on January 23, 2019. CDTFA reasserted its position by referencing the November 30, 2018, and October 30, 2018, memorandums.

20. Appellant submitted additional argument by e-mail on July 11, 2019. Appellant's representative explained that English is the second language for Z. Rashid and that Z. Rashid's English skills are poor, which was a contributing factor to the underreporting that occurred.

21. CDTFA responded to appellant's additional argument by memorandum on August 15, 2019, which incorporated an August 13, 2019, Memorandum from CDTFA's District staff. CDTFA noted that Z. Andesha had been operating the business since January 2004. CDTFA argued that the years of experience should have provided Ms. Andesha and Mr. Rashid an actual and constructive knowledge as to the requirements of the law. Also, CDTFA pointed out that the Certified Public Accountant (CPA), Mr. Ahmad, was hired to prepare the sales and use tax returns during the audit period. CDTFA argued that Mr. Ahmad should have had thorough knowledge to educate appellant on how to gather the correct sales amount from the POS reports in order to prepare the sales tax returns correctly.

22. On November 25, 2019, CDTFA issued a Supplemental Decision in which it found that fraud had been established by clear and convincing evidence.

23. This timely appeal followed.

DISCUSSION

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 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*).) It is CDTFA's burden to establish fraud by clear and convincing evidence. (Cal. Code Regs., tit. 18, § 1703(c)(3)(C); *Appeal of ISIF Madfish, Inc.*, 2019-OTA-292P.)

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. (*Ibid*.) Circumstantial evidence of intent to evade taxation includes, but is not limited to: substantial discrepancies between recorded amounts and reported amounts that cannot be explained (the indication that a deficiency is due to intent to evade increases in direct proportion to the ratio of the understatement); when sales tax or sales tax reimbursement is properly charged, evidencing knowledge of the requirements of the law, but not reported; inadequate records; failure to cooperate with tax authorities; and consistent, substantial understatements of income. (*Ibid*.; *Powell v. Granquist* (9th Cir. 1958) 252 F.2d 56, 60; *Rau's Estate v. Commissioner* (9th Cir. 1962) 301 F.2d 51, 54-55.)

Here, there is no direct evidence of a specific intent to evade sales and use tax. There are, however, several factors present, which, taken together, clearly, and convincingly establish that all or a signification portion of the understatement was due to fraud. For the reasons discussed below, we find that CDTFA has met its burden with clear and convincing evidence. The amount of underreporting during the audit period, which appellant no longer disputes, is significant. The

total understatement of reported taxable sales according to the second reaudit was $1,883,261. The error ratio based on the second reaudit was 235 percent. Appellant only reported 30 cents for every dollar of taxable sales it made during the audit period.[9] Nevertheless, appellant added sales tax reimbursement to the selling prices of all food consumed by patrons in the restaurant, which CDTFA has documented by the undercover purchase and the observation test.[10]

At the time of audit, the partnership had approximately seven years of experience operating the restaurant.[11] The business was previously operated as a partnership from January 1, 2004, through June 30, 2006, and one of the partners was Z. Andesha. On June 30, the seller's permit for the previous partnership was closed, and Z. Andesha opened another permit with the two other partners. The hours of operation, location, and kind of food remained the same or substantially similar between the prior partnership and the partnership during the audit period. Therefore, Ms. Andesha's experience operating the restaurant while maintaining an active seller's permit should have provided this partnership with actual and constructive knowledge of the requirements of the Sales and Use Tax Law.

Next, appellant accepted credit cards during the audit period. Appellant's credit card receipts for the period January 2009 through December 2010 totaled $1,157,669, while appellant reported total sales of only $697,424 for the same period. Thus, even without considering appellant's cash sales, we note that appellant chose not to report $460,245 of its credit card sales. Appellant has not provided a plausible explanation for its failure to report almost 40 percent of its credit card transactions during that period.[12] This substantial discrepancy is strong evidence of appellant's intent to evade the tax and clearly demonstrates that appellant fraudulently chose to understate its reported taxable sales.

In the October 1, 2018, RFR, appellant argued that CDTFA has offered no evidence of fraud other than the liability itself. Appellant asserted that the reporting errors identified in the

[9] In the original audited understatement, CDTFA calculated that appellant reported 27 cents out of every taxable dollar. The 27 cents amount was computed using the original audited understatement, as follows: $800,223 reported + $2,193,742 understatement = $2,993,965 audited taxable sales. $800,223 ÷ $2,993,965 = 26.7 percent. After the adjustments in the reaudits, the figure increases to about 30 cents out of every dollar. ($800,223 + $1,883,261 understatement = $2,683,484. $800,223 ÷ $2,683,484 = 29.8 percent.)

[10] It is undisputed that all of appellant's sales in the restaurant were subject to tax under the "80/80 rule." (See R&TC, § 6359(d)(6).)

[11] The time between January 1, 2004, through December 31, 2010, is six years, eleven months, and 27 days.

[12] $460,245 ÷ $1,157,669 = 39.8 percent.

audit can be attributed to appellant's lack of understanding of how to report its sales tax obligation correctly. Appellant argued that the primary reason for the inaccurate reporting is that appellant first inadvertently reported its taxable sales as total sales and then also took a deduction for its nontaxable sales. As support, appellant provided nine months of worksheets that appellant asserts: "appear to have been used to prepare the sales tax returns and have reconciled the recorded taxable and nontaxable sales with the amounts reported." Since appellant asserted that the understatement is the result of misunderstanding and unintentional error, appellant argues that the understatement was the result of negligence, rather than fraud.

With respect to the argument regarding the nine months of worksheets, appellant has not provided source documents to show that it used these worksheets to complete the sales and use tax returns. Likewise, appellant has not provided evidence to support the argument that these worksheets *were*, in fact, used to prepare sales and use tax returns. CDTFA considered all the audited sales to be taxable, and appellant no longer disputes the audit findings. In other words, it has been established that there were no exempt sales. Appellant accepts that fact, and there is no reliable evidence showing that appellant truly believed, at any point during the audit period, that it was making substantial exempt sales. As a result, the authenticity of the worksheets is uncertain. Moreover, the mechanics of appellant's theory do not work. Appellant claimed exempt food sales of only $316,609, while the audited understatement of reported taxable sales is $1,883,261. Thus, the understatement far exceeds a duplication in claimed exempt sales of food. We, therefore, find appellant's explanation unpersuasive.

With respect to the broader issue, that the understatement was merely the result of misunderstanding and unintentional error, appellant argued that the only evidence of fraud provided by CDTFA is the liability itself. In its December 17, 2018, letter, appellant cited to the case of *Marchica v. State Board of Equalizatio*n (1951) 107 Cal. App 2d 501, 509-510 and cases cited therein which states, "The burden of proving fraud is not sustained by merely establishing a deficiency." Appellant is correct that the deficiency itself is not adequate to support a finding of fraud. However, courts have also found that it is often necessary to make the determination of fraud based on circumstantial evidence. (*Bradford*, *supra*, 796 F.2d at p. 307; *Tenzer v. Superscope, Inc.*, *supra*, 39 Cal.3d 18.)

In this case, it is undisputed that there is a substantial discrepancy (an error rate of

235 percent).[13] It is also undisputed that appellant charged tax reimbursement with respect to its sales in the restaurant, which represented the majority of its sales. Thus, appellant was aware that its sales were subject to tax and that it collected tax reimbursement on those sales. Therefore, the question to be addressed is whether appellant has satisfactorily explained the substantial deficiency, with which it concurs, as being due to an honest mistake or to negligence. We have already rejected appellant's specific explanation regarding a purported duplication of claimed nontaxable sales on its returns. To address appellant's broader argument, that it simply was unaware of the understatement, we find CDTFA's reasons for asserting fraud to be compelling.

CDTFA noted that appellant chose to simply provide figures, rather than records, to its accountant. CDTFA also noted that appellant did not keep source documentation to support the figures provided. Appellant responded that "all returns prepared by accountants are prepared using sales provided by their clients." Appellant is incorrect; in some situations, the retailer provides records (i.e., cash register tapes, POS records, or sales journals) to the accountant, who is responsible for compiling the figures to be reported on returns. Moreover, CDTFA indicated that the accountant was a CPA and stated that any competent CPA would have been able to explain to appellant how to report correctly.[14] We find it relevant that the individual was a CPA, who should have been well-informed regarding accurate recordkeeping and reporting. While it is not direct evidence of fraud, we find appellant's failure to provide complete or, at least, accurate data to its accountant indicates that appellant intended to understate its reported taxable sales. We also find appellant's failure to ask its CPA for assistance on recordkeeping and reporting practices indicates that appellant intended to understate its reported taxable sales.

In addition, CDTFA indicated that appellant claimed a significant amount of exempt sales of food, totaling $364,514, on its sales and use tax returns, without providing any support. Appellant also provided invoices and contracts to CDTFA that purportedly represented bulk sales of cold food. When CDTFA contacted the purchasers, it found that the sales represented by those invoices and contracts were taxable sales of hot food. The argument by appellant, that adjustments were warranted for cold food, is evidence that it was aware that such sales of cold food were exempt, while sales of hot food were subject to tax. The fact that there is no evidence

[13] $1,883,261 ÷ $800,223 = 235.34 percent.

[14] In an August 13, 2019 Memorandum, CDTFA identified the individual as a CPA.

of sales of cold food indicates that appellant knowingly claimed exempt sales of food on its sales and use tax returns when it had made no such exempt sales.

We thus find that CDTFA has provided clear and convincing evidence of fraud. The evidence we find most persuasive is the substantial underreporting, throughout the audit period, along with a failure to request assistance in reporting or record keeping from its accountant or CPA; appellant's failure to report 40 percent of its credit card sales, as evidenced by credit card receipts; and the absence of a plausible explanation for the substantial understatement of reported taxable sales.

HOLDING

CDTFA has shown, by clear and convincing evidence, that the audited understatement of reported taxable sales was the result of fraud or intent to evade the tax.

DISPOSITION

Sustain CDTFA's decision to reduce the audited understatement of reported taxable sales from $2,193,742 to $1,883,261, to sustain the fraud penalty, and to otherwise deny the petition for redetermination.

DocuSigned by:
Josh Aldrich
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Josh Aldrich
Administrative Law Judge

We concur:

DocuSigned by:
Natasha Ralston
DE5000E566FD40F...
Natasha Ralston
Administrative Law Judge

DocuSigned by:
Andrea LH Long
272945E7B372445...
Andrea L.H. Long
Administrative Law Judge

Date Issued: 12/6/2021