OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18073396
	) CDTFA Case ID: 957172
ISIF MADFISH, INC.	) CDTFA Acct No. SR CH 101-144788
	)
	) Date Issued: May 2, 2019
	)
	)
	)

OPINION

Representing the Parties:

For Appellant: Adam Brewer, Attorney

For Respondent: Scott A. Lambert,Representative
Kevin C. Hanks, Representative
Stephen M. Smith, Attorney

A. KWEE, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, ISIF Madfish, Inc., dba Little Madfish (appellant), appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA), on a petition for redetermination of a May 27, 2016, Notice of Determination (NOD). The NOD is for the period October 1, 2008, through October 3, 2013, asserting $411,419.96 in tax, plus accrued interest, a negligence penalty of $36.71, a 25 percent fraud penalty of $56,076.14, and a 40 percent penalty of $57,366.14 for failing to remit sales tax reimbursement collected from customers (the 40 percent penalty). The 25 percent fraud penalty covers the period October 1, 2008, through September 30, 2013, and the 40 percent penalty covers the period October 1, 2011, through June 30, 2013.

Office of Tax Appeals (OTA) Administrative Law Judges Andrew J. Kwee, Jeffrey G. Angeja, and Neil Robinson heard this appeal on February 27, 2019, in Sacramento, California. At the hearing, the parties agreed that the only remaining issues on appeal are the imposition of the 25 and 40 percent penalties for periods on and after October 1, 2010. At the conclusion of the hearing, the evidentiary record was held open to allow for additional briefing on the issue of

whether the 40 percent penalty is a fraud penalty. Thereafter, the record was closed and this matter was submitted for decision on April 3, 2019.

ISSUES

1. Whether CDTFA established a basis for imposition of the 25 percent fraud penalty.
2. Whether the deficiency determination was timely issued with respect to amounts subject to the 40 percent penalty.
3. Whether CDTFA established a basis for imposition of the 40 percent penalty.

FACTUAL FINDINGS

1. Appellant operated a restaurant in California which it opened on or around October 1, 2008.
2. On or around November 5, 2010, a CDTFA[1] inspector visited appellant and inquired about the nature of its business. CDTFA determined that appellant was open daily and sold sushi and alcoholic beverages. During the inspection, appellant's manager reported that appellant made average daily sales of $2,000, and an employee named "June" could provide appellant's sales reports. After the inspection, CDTFA's inspector made a note in appellant's file that appellant's reported taxable sales do not reflect $2,000 in sales per day, and that the business may need to be audited.
3. During the period October 1, 2011, through June 30, 2013, appellant reported taxable sales of $420,846 (approximately $768 in average daily sales). During an audit, CDTFA examined appellant's own records for this period, which included recorded taxable sales and the amount of sales tax reimbursement collected from customers on those sales. According to its own records, appellant recorded taxable sales of $2,045,909 for this period. When compared to appellant's reported taxable sales, there are $1,625,063 in taxable sales that appellant recorded, but did not report on its returns.[2]

[1] The underlying audit activities were handled by CDTFA's predecessor, the State Board of Equalization (board). On July 1, 2017, CDTFA took over certain functions of the board, including administration of the sales and use tax law.

[2] The NOD asserts liability for six different categories of unreported taxable sales. This is one category. The final category covers the period October 1, 2013, through October 3, 2013 (4Q13). This period is not at issue, and we do not discuss it in this appeal. The discussion below pertains to the five remaining categories disclosed in the periods at issue in this appeal (4Q10 to 3Q13).

4. According to appellant's records, appellant collected $180,570 in sales tax reimbursement from its customers during the fourth quarter of 2011 (4Q11) through 2Q13. Of this amount collected, appellant only remitted $37,155 to CDTFA, resulting in $143,415 in sales tax reimbursement that appellant collected from its customers but did not remit to the state. On average, appellant's liability for unremitted sales tax reimbursement averaged $6,829.28 per month. Additionally, appellant's liability for unremitted sales tax reimbursement equals 79.42 percent of the total amount of appellant's tax liability, based on appellant's own recorded taxable sales data.
5. For the last full reporting period of July 1, 2013, through September 30, 2013, appellant reported $263,723 in taxable sales, and recorded taxable sales of $296,421. The difference results in an understatement of $32,698.
6. Upon further examination of appellant's records, CDTFA discovered there are many gaps in the sequence of the order numbers. For example, 7,732 transactions were missing or deleted from appellant's records for the period September 1, 2011, through November 27, 2013. CDTFA determined that the missing or deleted transactions represented additional unreported taxable sales that were not recorded in appellant's records.
7. For the period October 1, 2011, through September 30, 2013, CDTFA used a credit card sales ratio analysis to determine the amount of additional unreported taxable sales that were missing or deleted from appellant's records. Appellant does not dispute the audit methodology or the audited taxable sales as computed by CDTFA.
8. Based on its comparison of audited taxable sales of $2,902,695 for the period October 1, 2011, through September 30, 2013, with recorded taxable sales of $2,342,330 for the same period, CDTFA established additional unreported taxable sales of $560,365.
9. For the period October 1, 2010, through September 30, 2011, appellant did not provide detailed records containing recorded taxable sales. Based on its comparison of audited taxable sales of $1,015,251 with appellant's reported taxable sales of $359,805 for that period, CDTFA established unreported taxable sales of $655,446.
10. CDTFA also reviewed gratuities (tips). Receipts for happy hour and dinner included a mandatory tip, which was printed on the receipt. Appellant failed to report tax on its mandatory tips. For the period October 1, 2011, through June 30, 2013, appellant recorded $161,832 in mandatory tips. For the remaining periods at issue (4Q10 to 3Q11),

appellant did not provide records for its mandatory tips. CDTFA calculated audited taxable tips of $93,284 based on projecting the quarterly average amount from the period in which data was available.

11. For the period October 1, 2010, through September 30, 2013, appellant reported $1,155,873 in taxable sales, and CDTFA calculated audited taxable sales of $4,498,784, resulting in an understatement of $3,342,911. On average, appellant reported 25.69 percent of its taxable sales for the period at issue.

12. On October 4, 2013, during the pendency of the audit, appellant filed for bankruptcy.

13. On May 27, 2016, respondent issued a Notice of Determination (NOD) to appellant for the period October 1, 2008, through October 3, 2013, in the amount of $411,419.96 tax, plus applicable interest and penalties.

14. On June 24, 2016, appellant filed a timely petition for redetermination of the NOD. In a decision dated May 23, 2018, CDTFA denied the petition. This timely appeal followed.

15. On February 25, 2019, appellant submitted declarations signed under penalty of perjury from June Kim, an employee of appellant, and Moon Joo Lee, appellant's president. June Kim declared that she prepared the sales and use tax returns and she was never "instructed to fraudulently or intentionally misrepresent sales figures." Moon Joo Lee declared that he never advised his employees to "intentionally or fraudulently mispresent taxable sales."

16. During a pre-hearing conference held on February 7, 2019, appellant conceded tax and interest for all periods, and the parties agreed that only the 25 and 40 percent penalties remained at issue in this appeal. At the conference, OTA also put the parties on notice that, in deciding those two issues, OTA may consider whether the 40 percent penalty is a fraud penalty for purposes of the applicable statute of limitations and standard of proof. OTA raised this issue at the oral hearing held on February 27, 2019.

17. During this hearing, CDTFA conceded tax, interest, and penalties for all periods prior to October 1, 2010. CDTFA is asserting a 40 percent penalty for the sales tax reimbursement that was collected and not remitted during the period October 1, 2011, through June 30, 2013.[3] CDTFA calculated the 40 percent penalty by applying the

[3] Appellant recorded taxable sales of $296,421 for the period July 1, 2011, through September 30, 2011 (3Q11). This amount is not included in CDTFA's calculations for the 40 percent penalty.

penalty to the $143,415 in sales tax reimbursement that appellant collected from its customers and did not remit to the state, resulting in a penalty of $57,366.14. CDTFA is asserting a 25 percent fraud penalty for the other items of underreported taxable sales during the remaining periods at issue, with the exception of the unreported mandatory tips.

DISCUSSION

The 25 percent fraud penalty

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 must be established by clear and convincing evidence. (Cal. Code Regs, tit. 18, § 1703, subd. (c)(3)(C); see, e.g., *In re Renovizor's Inc. v. BOE* (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.

The R&TC does not define fraud, but there are many federal precedents that we may look to for guidance. Fraud can be proved by circumstantial evidence. (*Bradford v. Commissioner* (9th Cir. 1986) 796 F.2d 303, 307.) Such 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 finding of fraud, but repeated understatements in successive years, coupled with other circumstances showing intent to conceal or misstate taxable income, present basis for fraud finding. (*Rau's Estate v. Commissioner* (9th Cir. 1962) 301 F.2d 51, 54-55.)

In the instant case, there is no direct evidence of a specific intent to evade the tax. Nevertheless, there are a number of factors present which, when taken together, clearly and convincingly establish that all or a significant portion of the understatement was due to fraud. First, the amount of the underreporting is significant. Appellant's own records prove that appellant only reported 29.2 percent of the taxable sales that it recorded during the period October 1, 2011, through September 30, 2013 ($684,569 reported / $2,342,330 recorded). That

means, on average, *appellant's own records* prove that appellant reported less than one out of every three transactions that it recorded. Nevertheless, appellant collected the "sales tax" from all of its customers.

Second, there are unexplained deleted or missing transactions in appellant's records. There are approximately 7,732 deleted or missing sales transactions during this same period, resulting in $560,365 in additional unrecorded and unreported sales. After considering these additional transactions, appellant only reported 23.6 percent of its sales during this period ($684,569 reported / $2,902,695 audited) which, on average, is less than one out of every four taxable sales.

Third, appellant was unable to provide sales data for the earlier period of October 1, 2010, through September 30, 2011, and appellant's records overall were inadequate. Nevertheless, an audit of appellant's credit card merchant statements and deposits related there to established that the underreporting continued throughout the entire audit period at issue. Overall, for the period October 1, 2010, through September 30, 2013, appellant, on average, only reported 25.69 percent of its taxable sales to the state.

Finally, shortly after the start of the audit period, on November 5, 2010, appellant's manager reported to a CDTFA inspector that the business averaged $2,000 in sales per day and that June would be able to provide records for these sales, evidencing that appellant's management had a general understanding of the amount of its sales. Nevertheless, appellant reported less than $800 in sales per day for the audit period. Furthermore, June testified under penalty of perjury that she was an employee of the business (as opposed to, for example, an outside accountant) and that she prepared the tax returns at issue. As noted above, appellant's own records established that appellant made a significant number of sales that were not reported, and those records also included summary totals. We do not understand how, absent fraud, an employee of a business who prepared the sales and use tax returns, could fail to report such a significant number of the business' sales or to even review the business' own records in compiling those returns.

In summary, based on all the above facts and circumstances, we conclude that CDTFA has clearly and convincingly established fraud for all or a portion of all the quarters in the audit period. As such, a fraud penalty is statutorily authorized with respect to the entire deficiency, including all categories of unreported taxable sales asserted in the NOD.

The 40 percent penalty

The R&TC provides, in pertinent part, that any person who knowingly collects sales tax reimbursement and who fails to timely remit it to the state shall be liable for a penalty of 40 percent of the amount not timely remitted. (R&TC, § 6597, subd. (a)(1).) The penalty does not apply if the person's liability for unremitted sale tax reimbursement averages $1,000 or less per month or does not exceed 5 percent of the total amount of the tax liability for which the sales tax reimbursement was collected for the period in which the tax was due, whichever is greater. (R&TC, § 6597, subd. (a)(2)(A).) The law provides for relief of the 40 percent penalty for reasonable cause. (R&TC, § 6597, subd. (a)(2)(B).)

A preliminary question presented in this appeal concerns the construction and application of the word "fraud" in one specific provision of R&TC section 6487, subdivision (a), which provides in pertinent part that: "except in the case of fraud . . . every notice of a deficiency determination shall be mailed within three years." The specific issue we must determine is whether the penalty imposed by R&TC section 6597 requires a showing of such "fraud." If it does, then for the reasons described above, the statute of limitations would always be tolled when the 40 percent penalty is applicable, and CDTFA would be required to establish the 40 percent penalty by clear and convincing evidence.

Appellant contends that the three-year statute of limitations set forth in R&TC section 6487 applies with respect to the quarterly periods covered by the 40 percent penalty because the 40 percent penalty does not require a showing of fraud. As such, appellant contends that all or a substantial portion of the liability subject to the 40 percent penalty is time-barred from being asserted by CDTFA. On the other hand, CDTFA contends that the 40 percent penalty is a fraud penalty and, as such, the statute of limitations was suspended pursuant to R&TC section 6487. In support, CDTFA cites to its own internal policy which is to regard the 40 percent penalty as an evasion penalty and to look for clear and convincing evidence of fraud before asserting this penalty. (See, e.g., CDTFA Audit Manual § 0509.65.[4])

[4] As relevant, this section in CDTFA's Audit Manual explains CDTFA's internal policy: "If a recommendation is made to grant relief of a section 6597 evasion penalty, that in effect is a finding there was no fraud and thus the section 6597 penalty should not have been imposed."

Whether the 40 percent penalty in R&TC section 6597 is a "fraud" penalty

The primary purpose in construing a statute is to ascertain and give effect to the Legislature's intent. (*Dyna-Med, Inc. v. Fair Employment & Housing Commission* (1987) 43 Cal.3d 1379, 1377-1387 [superseded for reasons unrelated to the rules of statutory construction].) In most cases, the plain language of the statute is the best gauge of that intent. (*Honey Springs v. Board of Supervisors* (1984) 157 Cal.App.3d 1122, 1137.) "If the language is clear and unambiguous there is no need for construction, nor is it necessary to resort to indicia of the intent of the Legislature." (*Delaney v. Superior Court* (1990) 50 Cal.3d 785, 798.) R&TC section 6485 imposes a 25 percent penalty for "fraud." On the other hand, R&TC section 6597, which imposes the 40 percent penalty, sets forth the three elements for the penalty to apply and not one of these elements includes showing fraud or an intent to evade. To the contrary, R&TC section 6597 allows for relief of the 40 percent penalty for reasonable cause, which is not a defense to fraud (see R&TC § 6592) because the requisite intent for fraud is mutually exclusive with the ordinary business care and prudence standard for reasonable cause. Thus, it should be clear from the plain and unambiguous language of R&TC section 6597 that a showing of "fraud" is not required in order to impose the 40 percent penalty.[5]

We conclude that imposition of the 40 percent penalty does not require CDTFA to establish fraud. As such, the applicable standard of proof for CDTFA to impose the 40 percent

[5] CDTFA contends that the requirement in R&TC section 6597 that the state show the taxpayer "knowingly" collected sales tax reimbursement proves that it was intended to be a fraud or evasion penalty. Here, we understand CDTFA to be arguing that the knowledge requirement in R&TC section 6597 creates an ambiguity, because it would be inappropriate for us to resort to legislative intent to contradict the plain meaning of the statute. (See *Delaney v. Superior Court, supra,* 50 Cal.3d at 798.) Evidence of the intent behind R&TC section 6597 is modest but compelling. Here, section 6597 was added to the R&TC by Senate Bill (SB) 1449 (Stats. 2006, Ch. 252). The Senate Floor Analyses for the chaptered version of SB 1449 explains:

> ARGUMENTS IN SUPPORT: According to the author's office, the purpose of this bill is to enhance the penalty in cases where a retailer collects sales tax reimbursement from customers and fails to timely remit the tax to the state. Proponents assert that it is difficult for [the state] to establish that the failure of a retailer to remit sales tax reimbursement is due to fraud or the intent to evade taxes, which results in many retailers avoiding the 25 percent penalty. This bill does not require [the state] to demonstrate fraud or an intent to evade taxes in order to impose a 40 percent penalty for failure to remit sales tax reimbursement.

(Senate Floor Analyses, SB 1449, Aug. 8, 2006 [emphasis added].) We recognize that courts are generally reticent to rely on statements made by an individual member of the Legislature as an expression of the intent of the entire Legislature. (See *Walters v. Weed* (1988) 45 Cal. 3d 1, 10.) Nevertheless, under appropriate circumstances such evidence may be considered. (*Ibid*.) In this case, the statements by the author, and distributed to the senate, give valuable background to help understand the beneficial aim of the penalty, and the statements distributed to the senate are consistent with the clear and unambiguous language of the statute.

penalty is that of a preponderance of the evidence, as provided in OTA's Rules for Tax Appeals. (Cal. Code Regs, tit. 18, § 30219, subd. (c).) Furthermore, absent a showing of fraud, the three-year statute of limitations applies to the issuance of a deficiency determination imposing a 40 percent penalty. (See R&TC, § 6487, subd. (a).)

Whether CDTFA timely issued a deficiency determination to appellant as to periods subject to the 40 percent penalty

As indicated above, "except in the case of fraud . . . every notice of a deficiency determination shall be mailed within three years." (R&TC, § 6487, subd. (a).) A finding that any part of a deficiency determination was due to fraud is sufficient to suspend the statute of limitations to issue a deficiency determination as to the entire reporting period in which any part of the deficiency was due to fraud. (R&TC, §§ 6485, 6487.) Tolling of the statute of limitations for fraud as provided in R&TC section 6487 is also consistent with federal precedents, holding "if a return be fraudulent in any respect . . . it deprives the taxpayer of the bar of the statute for that year, and permits a general reaudit of the return throughout, and will toll the Statute of Limitations on the reaudit of any item of the tax." (*Lowy v. Commissioner* (2nd Cir. 1961) 288 F.2d 517, 520.) In the instant case, we already concluded above that CDTFA established, based on clear and convincing evidence, that a part of the deficiency for all quarterly reporting periods at issue in this appeal was due to fraud. Therefore, the statute of limitations to issue a deficiency determination was suspended under R&TC section 6487 as to all reporting periods and all audit items. In summary, we find that CDTFA timely issued the deficiency determination as to all periods.

Whether CDTFA established a basis for imposition of the 40 percent penalty

In order to impose the 40 percent penalty, CDTFA must first establish, by a preponderance of the evidence, that three requirements are met: (1) appellant knowingly collected sales tax reimbursement; (2) appellant failed to timely remit the excess sales tax reimbursement to the state; (3) the amount of sales tax collected and not remitted exceeds the requisite threshold. (R&TC, § 6597, subd. (a)(1)-(2).) First, appellant's own records reflected the amount of taxable sales and sales tax reimbursement that was collected. According to appellant, these amounts also included summary totals. Second, a review of appellant's sales tax returns established that the amount remitted fell far short of the amount collected. Third,

appellant's liability for unremitted sales tax reimbursement averaged $6,829.28 per month, and equals 79.42 percent of the total amount of appellant's tax liability, which far surpasses the $1,000 per month or 5 percent thresholds. Therefore, we find that CDTFA properly imposed the 40 percent penalty.

Next, appellant may establish reasonable cause as a basis for relief of the 40 percent penalty. (R&TC, § 6597, subd. (a)(2)(B).) R&TC section 6597 provides six examples of reasonable cause, none of which are relevant here. (R&TC, § 6597, subd. (b)(1).) Instead, appellant contends that the underreporting was not due to fraud or intentional misrepresentations. We find this argument unpersuasive because, for the reasons explained above, we have already concluded that CDTFA established by clear and convincing evidence that a part of the deficiency for all reporting periods was due to fraud. Furthermore, it is important to emphasize here that it is not necessary for CDTFA to establish fraud or intent to evade in order to impose this penalty, unless it also seeks to suspend the statute of limitations. (See R&TC, § 6487, subd. (a).) Otherwise, CDTFA must only establish, as we concluded above, that the three elements set forth in R&TC section 6597 are met.

HOLDINGS

1. CDTFA established a basis to impose the 25 percent fraud penalty.
2. The deficiency determination was timely issued with respect to amounts subject to the 40 percent penalty.
3. CDTFA established a basis to impose the 40 percent penalty.

DISPOSITION

CDTFA's action is sustained in part and reversed in part. Tax, interest, and penalties for all periods prior to October 1, 2010, shall be deleted pursuant to CDTFA's concession at the oral hearing. CDTFA's action in denying the petition is otherwise sustained.

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Andrew J. Kwee
Administrative Law Judge

We concur:

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Jeff Angeja
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Jeffrey G. Angeja
Administrative Law Judge

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Neil Robinson
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Neil Robinson
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