

**OFFICE OF TAX APPEALS**  
**STATE OF CALIFORNIA**

In the Matter of the Appeal of:

**J. HUERTA,**  
**dba Juan's Tacos**

) OTA Case No. 220710794  
) CDTFA Case ID: 2-284-904  
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**OPINION**

Representing the Parties:

For Appellant:

Maggie Monge, Representative

For Respondent:

Jason Parker, Chief of Headquarters Ops.

For Office of Tax Appeals:

Craig Okihara, Business Taxes Specialist III

M. GEARY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, J. Huerta (appellant) appeals a June 9, 2022 decision (Decision) issued by the California Department of Tax and Fee Administration (respondent) denying appellant's petition for redetermination of an October 15, 2020 Notice of Determination (NOD) for the period April 1, 2016, through March 31, 2020 (liability period).<sup>1</sup> The NOD is for tax of \$211,537.00, plus applicable interest, a 10 percent failure-to-file penalty of \$2,904.51, which respondent applied to the fourth quarter of 2019 (4Q19) and 1Q20, and a 25 percent fraud penalty of \$51,826.61, which respondent applied to the liability period. The NOD was based on an audit that determined a total deficiency measured by \$2,152,171, consisting of two audit

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<sup>1</sup> The NOD was timely for the period July 1, 2017, through the end of the liability period because it was issued within three years after the last day of the calendar month following the quarterly period for which the amount was determined. (R&TC, § 6487(a).) However, as explained in more detail below, absent a finding of fraud, which is alleged by respondent, the NOD is not timely (i.e., it will be time-barred) for the period April 1, 2016, through December 31, 2016. The same would have been true for the period January 1, 2017, through June 30, 2017, but for the fact that appellant executed two consecutive waivers of the statute of limitations, the last of which allowed respondent until January 31, 2021, to issue an NOD for the period January 1, 2017, through September 30, 2017. (R&TC, §§ 6487(a), 6488.)

items: unreported taxable sales of \$1,875,547 based on a credit card sales ratio analysis;<sup>2</sup> and unreported taxable sales of \$276,624 based on audited average daily sales.<sup>3</sup>

This matter is being decided on the basis of the written record because appellant waived the right to an oral hearing.

#### ISSUES<sup>4</sup>

1. Is an adjustment to the amount of unreported taxable sales warranted?
2. Is there clear and convincing evidence of appellant's fraud or intent to evade the payment of sales or use tax?
3. Is appellant entitled to relief from the failure-to-file penalty?

#### FACTUAL FINDINGS

1. Appellant, whose seller's permit was effective August 4, 2004, operated a restaurant in Santa Fe Springs, California, serving breakfast, lunch, and dinner. The restaurant was open daily from 7:00 a.m. to 12:00 a.m. Appellant also made sales at county fairs and other local events and provided catering services. Appellant ceased business operations on January 10, 2020, which became the effective close-out date for the seller's permit.<sup>5</sup>

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<sup>2</sup> In this Opinion, "credit card" refers to any of the customary forms of electronic payment. A credit card sales ratio analysis typically involves the use of third-party data, such as bank statements or IRS Forms 1099-K, which show amounts paid to a merchant by a bank, credit card company, or third-party network when the customer pays for goods or services using a debit card, credit card, PayPal, or similar form of non-cash payment. If a reasonable estimate of the ratio of such non-cash sales to total sales can be made, an equally reasonable estimate of total (i.e., cash and non-cash) sales can be made.

<sup>3</sup> The NOD also reflects a credit of \$4,231.

<sup>4</sup> Although it appears from appellant's request for appeal that the only contested issue is the measure of tax determined for 4Q19 and 1Q20, this Opinion will address all the issues addressed by respondent in its Decision.

<sup>5</sup> The seller's permit was originally issued to appellant for a restaurant in Bell Gardens, California. Appellant added the Santa Fe Springs location to the permit in 2010. The Bell Gardens location was closed, apparently prior to April 2013.

2. Respondent previously audited appellant for the period April 1, 2013, through March 31, 2016. The prior audit determined a \$1,296,571 deficiency measure consisting of differences between reported taxable sales and gross receipts reported on federal income tax returns (FITRs) (measured by \$855,899) and additional unreported taxable sales based on the credit card sales ratio analysis (measured by \$440,672).<sup>6</sup>
3. In the prior audit, respondent obtained Form 1099-K<sup>7</sup> data (1099-K data), which it compared to reported sales to calculate a credit card sales ratio of approximately 67 percent. To test the accuracy of this finding, respondent examined z-tapes provided by appellant for a three-week period in January and February 2017 to establish a credit card sales ratio of 31.84 percent.<sup>8</sup>
4. For the period April 1, 2016, through September 30, 2019, appellant reported total sales of \$1,729,231 on sales and use tax returns (SUTRs), claiming deductions of \$138,844 for sales tax reimbursement included in reported total sales, resulting in reported taxable sales of \$1,590,387.<sup>9</sup> Appellant did not file SUTRs for 4Q19 or 1Q20.
5. By letter dated December 20, 2019, respondent notified appellant that appellant had been selected for audit, and appellant was instructed to provide specific books and records, including general ledger and related journals, sales invoices, cash register tapes, purchases invoices and FITRs.
6. On February 20, 2020, appellant informed respondent that the business closed around December 25 of the previous year. On April 15, 2020, appellant informed respondent

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<sup>6</sup> The prior audit work papers state that respondent did not recommend a negligence penalty, in part because it was appellant's first audit and in part because respondent believed that appellant, whose primary language is Spanish, may have had difficulty understanding the Sales and Use Tax Laws. The work papers also indicate that respondent told appellant then how he could easily access Spanish versions of the Sales and Use Tax Laws online.

<sup>7</sup> Form 1099-K is an IRS form titled, "Payment Card and Third Party Network Transactions," which shows the monthly and annual amounts paid to a merchant by a bank, credit card company, or third party network, during a given time period. Form 1099-K includes payments made by any electronic means, including, but not limited to, credit cards, debit cards, and PayPal.

<sup>8</sup> Z-tapes are printed point-of-sale terminal (register) summaries of sales activity. Depending on the equipment and software, they can include breakdowns of sales by type and amount, including product or service, credit or cash, and taxable or nontaxable.

<sup>9</sup> It appears that respondent originally selected the period January 1, 2017, through December 31, 2019, for audit, that the period was extended to include 1Q20 when respondent learned that appellant ceased operations during that quarter, and that the period April 1, 2016, through December 31, 2016, was also added when respondent concluded that the deficiency was due to fraud or intent to evade.

that appellant provided sales receipts to an accountant, who prepared the SUTRs.

Appellant also informed respondent that many records were destroyed when appellant closed the business. Appellant provided no records to respondent for the audit and has provided no records during this appeal.

7. Appellant's failure to provide books and records effectively prevented respondent from determining how appellant prepared its SUTRs. The lack of records also prevented respondent from using a direct audit approach to verify reported amounts.<sup>10</sup> Consequently, respondent used an indirect audit method to verify appellant's reported taxable sales.
8. Respondent obtained 1099-K data for April 1, 2016, through December 31, 2018, and decided to compute sales using the credit card sales ratio analysis.<sup>11</sup> Respondent compiled credit card sales of \$977,875 for that period. For each quarter, respondent divided credit card sales by 1 plus the applicable sales tax rate to compute credit card sales, excluding sales tax reimbursement (ex-tax).<sup>12</sup> Those sales totaled \$895,507. Respondent compared ex-tax credit card sales to reported taxable sales of \$1,306,568 for April 1, 2016, through December 31, 2018, to compute a credit card sales ratio of 68.54 percent ( $\$895,507 \div \$1,306,568$ ). This meant that, according to sales reported by appellant, only about 31 percent of appellant's customers paid with cash.
9. Because respondent believed that the 31.84 percent credit card sales ratio established in the prior audit was more reliable, having been based on an analysis of z-tapes showing three weeks of actual sales during the liability period, respondent concluded that appellant had underreported taxable sales for the liability period.
10. Respondent divided appellant's ex-tax credit card sales for the period April 1, 2016, through December 31, 2018, by the credit card sales ratio of 31.84 percent to compute audited taxable sales for that period of \$2,812,521. Using reported taxable sales of \$1,306,568 for the same period, respondent computed unreported taxable sales of

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<sup>10</sup> A direct audit method is one that enables the auditor to determine taxable sales directly from business records without estimates or extrapolation, such as by simple tabulation of taxable sales evidenced by sales invoices or cash register tapes. A direct audit approach based on complete and accurate business records is the most accurate.

<sup>11</sup> Respondent was unable to obtain 1099-K data for five of the 16 quarters under audit.

<sup>12</sup> Respondent did not make an adjustment for credit card tips because the prior audit found that tips were not made on credit card sales.

\$1,505,953 for that period. Respondent calculated error ratios by dividing unreported taxable sales by reported taxable sales on a quarterly basis,<sup>13</sup> for 2018 (130.23 percent), and for the period April 1, 2016, through December 31, 2018 (115.26 percent).

Respondent applied the quarterly error ratios to the corresponding reported quarterly taxable sales for the period April 1, 2016, through December 31, 2018, and the 2018 error ratio to reported taxable sales for the period January 1, 2019, through

September 30, 2019, thereby computing unreported taxable sales of \$1,875,547 for April 1, 2016, through September 30, 2019 (audit item 1).

11. For the two quarters for which appellant failed to file SUTRs, respondent computed audited taxable sales on the basis of audited average daily taxable sales for the period April 1, 2016, through September 30, 2019. Respondent first computed average daily taxable sales for that period of \$2,712 by adding reported taxable sales (\$1,590,387) to audited unreported taxable sales (\$1,875,547) and dividing the total by the number of days (1,278) in that period. It then multiplied that daily average by the number of days in 4Q19 and 1Q20 (102) to calculate audited taxable sales of \$276,624 ( $\$2,712 \times 102$  days), which was also the measure of unreported taxable sales for that period (audit item 2).
12. In total, respondent computed unreported taxable sales of \$2,152,171 ( $\$1,875,547 + \$276,624$ ) for the liability period.<sup>14</sup>
13. On the basis of its findings that appellant knew it was required to accurately report taxes due but substantially, consistently, and knowingly underreported taxes due, failed to maintain and provide books and records, and failed to file SUTRs for two quarters, respondent concluded that the deficiency was due to fraud or intent to evade the payment of taxes.
14. Respondent issued the October 15, 2020 NOD to appellant.

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<sup>13</sup> The quarterly error ratios for that period varied between 90.7 percent (for 2Q16) and 162.62 percent (for 4Q17)

<sup>14</sup> Although the determined deficiency also included unreported City of Santa Fe Springs district tax, which became effective beginning April 1, 2019, and subjected taxable sales in the city to an additional 1 percent tax rate, appellant has not disputed this audit item, so this Opinion will not discuss it further.

15. Appellant filed a timely petition for redetermination disputing the NOD in its entirety.
16. Respondent held an appeals conference with appellant, and subsequently issued the Decision denying the petition.
17. This timely appeal followed.

### DISCUSSION

#### Issue 1: Is an adjustment to the amount of unreported taxable sales warranted?

California imposes sales tax on a retailer's retail sales of tangible personal property sold in this state measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, §§ 6012, 6051.) For the purpose of the proper administration of the Sales and Use Tax Law and to prevent the evasion of the sales tax, the law presumes that all gross receipts are subject to tax until the contrary is established. (R&TC, § 6091.) Although gross receipts from the sale of "food products" are generally exempt from the sales tax, sales of hot food and sales of food served in a restaurant are subject to tax. (R&TC, § 6359(a), (d)(1), (d)(2), and (d)(7).) It is the retailer's responsibility to maintain complete and accurate records to support reported amounts and to make them available for examination. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).) The records must be maintained for a minimum of four years unless respondent specifically agrees otherwise. (Cal. Code Regs., tit. 18, § 1698(i), (j).)

When respondent is not satisfied with the amount of tax reported by the taxpayer, or in the case of a failure to file a return, respondent 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, respondent has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Talavera*, 2020-OTA-022P.) Once respondent has met its initial burden, the burden of proof shifts to the taxpayer to establish that a result differing from respondent's determination is warranted. (*Ibid.*) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid.*) To satisfy its burden of proof, a taxpayer must prove both: (1) that the tax assessment is incorrect and (2) a measure of tax more accurate than that determined by respondent. (*Appeal of AMG Care Collective*, 2020-OTA-173P.)

Respondent used records in its possession and accepted accounting procedures to determine the accuracy of appellant's returns. Because of appellant's destruction of the business records, which was in violation of its obligation to maintain and provide such records for audit, respondent was unable to verify sales reported on appellant's SUTRs for the liability period using a direct audit method. Respondent's only option was to use an indirect audit approach. Respondent's initial doubts regarding the accuracy of appellant's reporting, when it found that the credit card sales ratio calculated on the basis of reported sales was more than twice the ratio determined in the prior audit, were reasonable. Given that the 1099-K data was the only sales information available to verify reported sales, respondent's use of a credit card sales ratio analysis to perform the audit was both reasonable and rational. Finally, respondent correctly performed the credit card sales ratio analysis. The 1099-K data is reliable evidence of appellant's credit sales, and the Office of Tax Appeals (OTA) finds that the credit card sales ratio developed in the prior audit was the most reliable ratio shown by the evidence. On these bases, OTA concludes that respondent's determination is reasonable and rational. Consequently, the burden of proof shifts to appellant.

In the request for appeal filed with OTA, appellant argues that the determination is inaccurate and at least implies that there is evidence to support that argument. Appellant urges OTA to review the evidence, including bank statements. However, appellant has provided no evidence, and there is nothing in the record to show error in respondent's analysis or determination, or a measure of tax more accurate than what respondent has determined. On the basis of the record, OTA finds that no adjustment to the amount of unreported taxable sales is warranted.

Issue 2: Is there clear and convincing evidence of appellant's fraud or intent to evade the payment of sales or use tax?

As stated above, respondent applied a 25 percent fraud penalty to the liability, and the NOD will be time-barred for the period April 1, 2016, through December 31, 2016 absent a finding that some part of the determination is due to fraud or an intent to evade the Sales and Use Tax Law. R&TC section 6485 states that, "[i]f any part of the deficiency for which a deficiency determination is made is due to fraud or an intent to evade this part or authorized rules and regulations, a penalty of 25 percent of the amount of the determination shall be added thereto." Fraud or intent to evade must be established by clear and convincing evidence. (Cal. Code

Regs., tit. 18, § 1703(c)(3)(C).) The burden of proof is on respondent. (See also *State Bd. of Equalization v. Renovizor's Inc.* (9th Cir. 2002) 282 F.3d 1233, 1240-1241).

Direct evidence of a taxpayer's fraudulent intent or intent to evade the payment of taxes due is not required. (*Rau's Estate v. Commissioner* (9th Cir. 1962) 301 F.2d 51, 54-55.)<sup>15</sup> The required intent can be proved through circumstantial evidence. (*Bradford v. Commissioner* (9th Cir. 1986) 796 F.2d 303, 307.) An understatement alone may not be sufficient to warrant finding of fraud, but repeated understatements in successive years, combined with other circumstances showing intent to conceal or misstate taxable income, provides a sufficient basis for a finding of fraud. (*Appeal of ISIF Madfish, Inc.*, 2019-OTA-292P [citing *Rau's Estate, supra.*].) Other "badges" of fraud include inadequate records, failure to file tax returns, implausible or inconsistent explanations of behavior, concealment of assets, failure to cooperate with tax authorities, and a taxpayer's lack of credibility. (*Ibid.*)

The clear and convincing evidence of fraud or intent to evade the payment of tax – or the application of any provision of Sales and Use Tax Law – begins with the fact that appellant's reporting had been found significantly deficient in the prior audit under circumstances similar to those OTA examines in this appeal. Although OTA cannot determine how reported sales compares to gross receipts reported to the IRS for any part of the liability period because appellant did not provide FITRs, the evidence shows that appellant failed to report taxable sales of \$1,296,571 for the prior three-year audit period, and that respondent determined \$440,672 of those based on a credit card sales ratio analysis similar to the one relied on for the audit at issue here. Also similar to the circumstances before OTA here, reliable 1099-K data compared to reported sales suggested a credit card sales ratio of approximately 67 percent, though the ratio was closer to 69 percent in the instant audit, while a three-week test of actual z-tapes *during the liability period* established a credit card sales ratio slightly less than 32 percent. That test provides the only reliable evidence in OTA's record of appellant's credit sales ratio, in part because of appellant's apparent and inexplicable destruction of his business records and cessation of business shortly after respondent informed appellant that another tax audit – the one at issue here – was about to begin.

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<sup>15</sup> Because there are few cases that discuss R&TC section 6485, OTA considers, by analogy, the standards that apply under Internal Revenue Code section 6663, the federal income tax fraud penalty.

According to respondent's memorandum regarding the fraud penalty, appellant reported average quarterly sales of \$206,273 for the prior audit period. For the 14 quarters in the liability period for which appellant filed SUTRs (2Q16 through 3Q19), appellant reported average quarterly sales of \$113,599 (a total of \$1,297,435); but a comparison of the 1099-K data for the two audits reveals that average credit sales for the period for which 1099-K data was available showed an *increase* of almost 33 percent. It is also worth noting that for 2013, 2014, and 2015, appellant reported income on FITRs that was, on average, over \$300,000 more than sales reported on appellant's SUTRs; but appellant has prevented respondent and OTA from making the same comparison here because appellant did not provide FITRs for the audit.

In summary, the evidence shows a consistent pattern of substantial underreporting under circumstances that establish appellant's intent to fraudulently misrepresent taxable sales in an effort to intentionally evade the payments of taxes. On this basis, OTA finds that there is clear and convincing evidence of appellant's fraud or intent to evade the payment of sales or use tax.

Issue 3: Is appellant entitled to relief from the failure-to-file penalty?

It is undisputed that appellant did not file SUTRs for 4Q19 or 1Q20. Respondent correctly imposed 10 percent penalties for those quarters pursuant to R&TC section 6591. R&TC section 6592 provides that this failure-to-file penalty may be relieved if the taxpayer's failure to file returns taxes was due to reasonable cause and circumstances beyond the taxpayer's control and occurred notwithstanding the exercise of ordinary care and in the absence of willful neglect. (R&TC, § 6592(a).) Subject to certain exceptions not applicable here, in order to obtain relief, the taxpayer must submit to respondent a statement under penalty of perjury setting forth the facts upon which the person bases the claim for relief. (R&TC, § 6592(b).) According to respondent's Decision, respondent informed appellant regarding this requirement at the time of the appeals conference on November 16, 2021. Appellant had not submitted the required statement by the time respondent issued its Decision, and no such statement appears in the evidence. Consequently, appellant is not entitled to relief of the failure-to-file penalty.

HOLDINGS

1. No adjustment to the amount of unreported taxable sales is warranted.
2. There is clear and convincing evidence of appellant’s fraud or intent to evade the payment of sales or use tax.
3. Appellant is not entitled to relief from the failure-to-file penalty.

DISPOSITION

Respondent’s action denying appellant’s petition for redetermination is sustained.

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 Michael F. Geary  
 Administrative Law Judge

We concur:

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 Andrew J. Kwee  
 Administrative Law Judge

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 Sheriene Anne Ridenour  
 Administrative Law Judge

Date Issued: 6/13/2023