OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	OTA Case No.: 20096662
	CDTFA Case ID: 279-875
4JR ENTERPRISES, INC.	

OPINION

Representing the Parties:

For Appellant:	Aksel Bagheri, Attorney
For Respondent:	Randy Suazo, Hearing Representative Christopher Brooks, Attorney Jason Parker, Chief of Headquarters Ops.
For Office of Tax Appeals:	Lisa Burke, Business Taxes Specialist III

M. GEARY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, 4JR Enterprises, Inc.[1] (appellant) appeals a December 12, 2019 decision (Decision) issued by the California Department of Tax and Fee Administration (respondent),[2] partially denying appellant's petition for redetermination of an April 5, 2018 Notice of

[1] This is one of three business entities owned by A. Rabadi (Rabadi entities) that operated as many as 14 service stations and minimarts in California during the period 2010 through 2016. Respondent issued Notices of Determination to the three Rabadi entities asserting combined liabilities of $4,782,240 in tax, plus interest, and $1,195,561 in penalties. All three Rabadi entities appealed, and, with the agreement of the parties, the Office of Tax Appeals (OTA) consolidated the three appeals for hearing with the understanding that a separate opinion would be issued to each appellant.

[2] Sales and use taxes (and other business taxes and fees) were formerly administered by the State Board of Equalization (BOE). In 2017, the California Legislature transferred functions of BOE relevant to this case to respondent. (Gov. Code, § 15570.22.) The effective date of the transfer of all but adjudicatory functions was July 1, 2017. (Adjudicatory functions were transferred to OTA effective January 1, 2018.) When this Opinion refers to events that occurred before July 1, 2017, "respondent" refers to BOE.

Determination (NOD) for tax of $2,279,006,[3] plus applicable interest, and a fraud penalty of $569,752 for the period January 1, 2010, through March 31, 2016 (liability period).[4]

Office of Tax Appeals (OTA) Administrative Law Judges Keith T. Long, Josh Lambert, and Michael F. Geary held an oral hearing for this matter in Cerritos, California, on February 13, 2024. At the conclusion of the hearing, the parties submitted the matter, and OTA closed the record.

ISSUES

1. Are adjustments to the disputed measures of unreported taxable sales warranted?[5]
2. Does clear and convincing evidence establish fraud[6] sufficient to avoid the bar of the statute of limitations and to support the imposition of the fraud penalty?[7]

FACTUAL FINDINGS

1. At various times during the liability period, appellant operated as many as six service stations with minimarts, three in Los Angeles County and three in Ventura County.[8]
2. A. Rabadi, appellant's president and sole owner, has owned and operated similar businesses in California since 1986, eight as sole proprietorships and 16 through solely owned corporations. Of the nine seller's permits issued to A. Rabadi or his companies, five had prior audits with deficit results for which respondent assessed a fraud penalty. During the liability period, A. Rabadi owned three business entities (Rabadi entities) that operated multiple service stations with minimarts. The entities, all California corporations, were appellant, High Five Enterprises (High Five), and JR Fueling.

[3] OTA will round dollar amounts in this Opinion, which may cause some totals to be slightly different than amounts stated in the audit work papers.

[4] Respondent's Decision reduced the understated measure of tax from $49,778,190 to $43,119,665 (which will result in reductions to the tax and penalty) and denied the remainder of the petitioned amount.

[5] During respondent's internal appeals process, appellant disputed all measures of unreported taxable sales, including unreported minimart sales and propane sales. Minimart sales and propane sales are no longer in dispute. Thus, the only sales that remain at issue are gasoline and diesel fuel sales.

[6] References to "fraud" in this document should be read to refer to fraud or intent to evade the Sales and Use Tax Law or authorized rules and regulations.

[7] The NOD will be barred by the statute of limitations for any quarter during the period January 1, 2010, through March 31, 2013, for which fraud is not established by clear and convincing evidence.

[8] One of the locations also sold diesel fuel.

3. R. Rabadi, the sister of A. Rabadi, was at one time the corporate secretary of appellant. According to R. Rabadi's hearing testimony, she was primarily responsible for routine, day-to-day management of the retail operations for all service stations and minimarts owned and operated by the Rabadi entities, but A. Rabadi made all important decisions regarding those businesses.
4. J. Humphrey is a bookkeeper and tax preparer who has been maintaining the books and handling all of the tax filings for the Rabadi entities and several other businesses owned by A. Rabadi for many years and continued to do so at least to the date of the hearing in this appeal. According to respondent's records, J. Humphrey was also the bookkeeper for three of the nine previous seller's permits associated with A. Rabadi. According to A. Rabadi, J. Humphrey also handled accounts for 40 to 60 other clients.
5. Appellant used a point-of-sale (POS) system at its service stations and minimarts.[9] Cashiers ran a sales report at the end of each shift. That report showed total sales, credit sales, and cash sales. It would also have shown taxable and nontaxable sales.
6. The following chronology is described in Assignment Activity Histories contained in the workpapers from the audits of the Rabadi entities:
    - The first of the audits of the Rabadi entities was the JR Fueling audit. That audit was begun by an auditor (auditor 1) who was not involved in the audits of 4JR and High Five. Eventually, the JR Fueling audit was reassigned to the auditor (auditor 2) who was conducting the audits of 4JR and High Five.
    - On April 28, 2016, respondent mailed the first audit notice to JR Fueling.
    - On May 10, 2016, J. Humphrey left a voicemail message for respondent.
    - On June 7, 2016, respondent sent a letter to appellant informing it of respondent's intention to conduct an audit for the period April 1, 2013, through March 1, 2016, and describing the books and records that appellant should provide for examination. R. Rabadi agreed to make the requested books and records available by July 8, 2016.

[9] A POS system typically includes one or more terminals, which are the modern equivalent of a cash register. Depending on the equipment and software, POS systems can generate reports that summarize sales activity for the period of time selected by the operator. These reports can include breakdowns of sales by type and amount, including product or service, credit or cash, and taxable or nontaxable.

- On June 17, 2016, R. Rabadi reported to respondent that she would probably be handling appellant's audit and that she needed to speak with A. Rabadi.
- On June 22, 2016, J. Humphrey contacted respondent and reported that "the taxpayer" had asked him to call respondent, apparently to explain that he would not be handling the JR Fueling audit because he did not have time.
- On July 20, 2016, R. Rabadi reported to respondent that the records were not yet available because appellant's accountant "has been very busy."
- On July 25, 2016, R. Rabadi made an August 2, 2016 appointment with auditor 2 to drop off books and records that she had available. R. Rabadi also made an August 2, 2016 appointment to meet with auditor 1.
- On August 2, 2016, R. Rabadi met with the 4JR auditor and informed the auditor that she had no records to provide because a shredding company had mistakenly taken the books and records from the storage room where she kept them and shredded them in February 2016.[10] R. Rabadi did not keep the appointment with auditor 1.
- R. Rabadi told respondent that J. Humphrey did not retain copies of the monthly sales reports, which she provided to J. Humphrey for preparation of appellant's sales and use tax returns (SUTRs), and that there was no way to reproduce the reports. R. Rabadi eventually provided copies of appellant's federal income tax returns for 2013, 2014, and 2015.
- On August 5, 2016, respondent informed R. Rabadi that all three Rabadi entities would be audited.
- On August 16, 2016, R. Rabadi informed respondent that there were no records available for High Five.
- On August 25 and August 30, 2016, in response to respondent's questions about the availability of POS reports for periods after the alleged shredding incident in February 2016, R. Rabadi stated that she discarded those reports after she made notes from them, and the reports could not be reproduced after three days.

[10] In her hearing testimony, R. Rabadi stated that J. Humphrey did not want to store the records, so R. Rabadi and a friend rented a storage room for their records. She testified that the friend decided to shred his or her records and that appellant's records (and the records of the other two Rabadi entities) were also shredded when the friend failed to properly supervise the shredding operation.

R. Rabadi also stated that she had discarded her notes from all periods prior to July 2016, and she did not believe that the auditor would be able to understand her notes from July and August. Respondent instructed R. Rabadi to begin retaining all of appellant's business records immediately.

- On September 6, 2016, R. Rabadi provided sales summary reports for five of appellant's service stations and minimarts for the period August 29, 2016, through September 4, 2016 (one week).[11]
- On September 14, 2016, R. Rabadi was still indicating to respondent that records for JR Fueling would be provided by the end of the month.

7. In November 2016, during a discussion of the preliminary findings for the audits of appellant and High Five, R. Rabadi argued that the sales summary reports that she had provided for the one-week period did not properly represent appellant's sales of carbonated beverages in its minimarts. To support a reduction to audited taxable sales of minimart merchandise, R. Rabadi provided sales summary reports for the remainder of September 2016.

8. Appellant added sales tax reimbursement to the selling prices for minimart merchandise and propane. Sales tax reimbursement was included in the selling prices of gasoline and diesel fuel.

9. In January 2017, respondent extended the liability period back to January 1, 2010, and expanded the scope of the audit accordingly based on its suspicion that appellant's SUTRs were fraudulent.

10. Because appellant failed to provide books and records from the liability period, respondent relied on information from Oil Price Information Service (OPIS)[12] to compute appellant's average selling prices of regular gasoline for each quarterly period from January 1, 2010, through December 31, 2015.[13] Respondent relied on an observed selling price differential at appellant's service stations to determine that appellant's average prices of mid-grade and premium gasolines were $0.10 more and $0.20 more per gallon,

[11] One of appellant's six locations was closed on February 22, 2016.

[12] OPIS maintains a comprehensive database of retail selling prices of regular gasoline for individual service stations. OPIS does not provide selling prices for mid-grade or premium gasoline.

[13] Average selling prices were not then available for 2016.

respectively, than the price of regular; and it used those adjusted prices to compute the average selling prices of mid-grade and premium gasoline. Respondent then computed audited weighted average gasoline selling prices for each quarterly period for the three service stations in Los Angeles County and for the three service stations in Ventura County on the basis of the ratios of sales of each grade of gasoline calculated from appellant's sales reports for the period August 29, 2016, through September 30, 2016.[14]

11. Respondent did not have OPIS information for the first quarter of 2016 (1Q16). Therefore, to compute appellant's average gasoline selling prices for 1Q16, respondent obtained average selling prices for gasoline sold in the Los Angeles area compiled by the U.S. Department of Energy (DOE).[15] Respondent then compared the weighted average prices computed from the OPIS information for appellant's service stations in Los Angeles County and Ventura County in 2015 with the DOE weighted average prices for gasoline sold in the Los Angeles area in 2015, and found that the prices computed from the OPIS information for the Los Angeles County service stations and the Ventura County service stations were $0.3934 higher and $0.2646 higher, respectively, than the DOE average prices. Accordingly, respondent added $0.3934 and $0.2646 to the DOE average prices to establish audited weighted average gasoline selling prices for appellant's service stations in Los Angeles County and in Ventura County, respectively, for 1Q16.

12. To compute audited taxable gasoline selling prices for the service stations in Los Angeles and Ventura Counties, respondent adjusted the audited weighted average selling prices by the applicable sales tax rates for each quarterly period to exclude the sales tax reimbursement included in the gasoline selling prices. Respondent did not exclude federal excise tax from the measure of gasoline sales tax.

[14] For the Los Angeles County service stations, the ratios were 54.8 percent for regular, 17 percent for mid-grade, and 28.2 percent for premium. For the Ventura County service stations, the ratios were 67.62 percent for regular, 11.76 percent for mid-grade, and 20.61 percent for premium.

[15] DOE surveys service stations once a week in a given geographic area, typically on Mondays, and computes an average selling price for all surveyed service stations in that geographic area. Whereas the OPIS gasoline selling prices are for individual service stations (in this case, appellant's service stations), the DOE gasoline selling prices are an average of several service stations in a geographic area.

13. Respondent divided the amount of sales tax that appellant prepaid to its gasoline vendors by the applicable prepaid sales tax rates to compute the number of gallons of gasoline appellant purchased for each quarter in the liability period.[16] Respondent then multiplied the number of gallons purchased by the audited taxable gasoline selling prices for each quarter to compute audited taxable gasoline sales of $140,683,398, which exceeded appellant's reported taxable gasoline sales for the liability period by $37,695,284.
14. Respondent used the same procedures to compute audited diesel fuel sales of $1,235,486, which it compared to reported diesel fuel sales to compute unreported taxable sales of diesel fuel of $261,558.[17]
15. Respondent also computed unreported taxable sales of minimart merchandise of $11,245,474, unreported taxable sales of propane of $434,800, and unreported taxable cigarette rebates of $141,074 for the liability period. OTA does not provide details of the calculations of these amounts because they are not in dispute. In total, respondent established unreported taxable sales of $49,778,190 in the original audit ($37,695,284 + $261,558 + $11,245,474 + $434,800 + $141,074).
16. Based, at least in part, on A. Rabadi's extensive experience owning and operating service stations, on his long association with bookkeeper J. Humphrey, and on their collective experience with sales and use tax audits, respondent concluded that appellant was sufficiently knowledgeable about recordkeeping and reporting requirements under the Sales and Use Tax Law to have understood its obligation to maintain accurate business records and to accurately report recorded amounts. Respondent found that appellant nevertheless failed to maintain and provide the required records, failed to adequately explain and document its reporting methodology, and failed to report taxable sales of $49,778,190, which represented an error ratio of 46.34 percent when compared to reported taxable sales of $107,415,377. Respondent thus determined that appellant retained more than $2.27 million in sales tax reimbursement it had collected from its customers during the liability period. Respondent concluded that appellant had

[16] Respondent has the ability to generate reports that show the amount of sales tax appellant prepaid to its distributors and wholesalers.

[17] In addition to excluding sales tax from the measure for diesel fuel sales, respondent also deducted the state diesel fuel excise tax.

intentionally attempted to evade the payment of tax, and on that basis, respondent added a 25 percent penalty for fraud to the audit liability.

17. Respondent issued the April 5, 2018 NOD to appellant.

18. Appellant filed a timely petition for redetermination of the NOD.

19. As part of respondent's internal appeals process, the Rabadi entities and respondent participated in an appeals conference on July 9, 2019. Appellant argued at the conference that an analysis of bank deposits would produce a more accurate result.[18] After the appeals conference, appellant provided additional documentation to support its contention. The additional documentation consisted of a yearly summary of cash and credit card sales for 2011 and 2012; a summary by quarter of sales made by each of appellant's six locations during 2Q13, 3Q13, and 4Q13; a schedule compiling the deposits into multiple bank accounts during 2011; copies of bank statements for its payroll account for January, February, and April 2011; copies of bank statements for its main bank account for January, March, April, May, and June 2011; and copies of its bank statements for an additional bank account for January and February 2011.

20. Respondent examined the additional documentation and found that deposits of $24,042,885 shown in the bank statements provided for 2011 exceeded appellant's reported total sales of $20,222,388 by $3,820,497 for that year and were $10,503,828 less than total combined credit card and cash deposits of $34,546,713 shown in appellant's schedule of deposits for 2011. Respondent concluded that the incomplete bank statements were not reliable evidence of appellant's sales and it recommended no adjustment.

21. Respondent's Decision ordered a reaudit of minimart sales only and otherwise denied appellant's petition. The reaudit reduced the measure of unreported taxable minimart sales from $11,245,474 to $4,586,949, a reduction of $6,658,525. Thus, the total measure of unreported taxable sales in the reaudit was reduced from $49,778,190 to $43,119,665, of which appellant contests the measures of unreported gasoline and diesel fuel sales totaling 37,956,842 ($37,695,284 + $261,558), and the unreported (and

[18] In the context of a sales and use tax audit, a bank deposit analysis presumes all deposits into the business bank accounts constitute revenue from sales unless evidence establishes otherwise. To be useful for estimating a taxable sales measure, all revenue must have been deposited into the account(s), and respondent must be able to segregate deposits from nontaxable sales revenue, tips, sales tax reimbursement, and possibly other categories.

unremitted) sales tax reimbursement collected from customers was reduced from $2.27 million to just under $1.72 million.

22. This timely appeal followed.

23. On appeal to OTA, appellant provided additional documentary evidence, including:

- Documents to show that in 2017 (approximately a year after the liability period), one of appellant's suppliers, ConocoPhillips Company Payment Systems (Conoco), was also a credit payment processor and that it offset amounts that appellant owed for gasoline against amounts Conoco owed to appellant for credit card sales processed by Conoco.
- A list of its credit card processors that purportedly served the Rabadi entities in 2011 and what appellant represents as the Forms 1099-K the processors filed with the IRS for 2011 and 2012.[19]
- What appellant represented to be all Form 1099-K data obtained from the IRS, but which, in fact, appears to be only part of the 1099-K data provided by the IRS to appellant. Appellant stated at the hearing that it provided as its Exhibit 5 all 19 pages that the IRS purportedly sent directly to appellant's representative. OTA's review of Exhibit 5 reveals that it consists of a fax cover sheet from R. Rabadi to appellant's representative and the following three groups of documents. The first group starts with a fax cover sheet that indicates the IRS sent R. Rabadi 20 pages (including the cover page) of 1099-K data pertaining to appellant. However, there are only seven pages, marked "1 of 19" through "7 of 19" attached to that cover sheet. Those pages are transcripts of Forms 1099-K, and the text indicates that appellant provided 6 of 10 transcript pages for 2011 and 8 of 16 transcript pages for 2012. A second group of documents begins with a fax cover sheet from the IRS to R. Rabadi that indicates that it accompanied six pages pertaining to Forms 1099-K issued to JR Fueling. Appellant provided only 2 of 6 pages, which were clearly marked "1 of 6" and "2 of 6." The transcript text indicates appellant provided 2 of 8 pages for 2011 and 2 of 14 pages for 2013.

[19] Form 1099-K is an Internal Revenue Service form titled "Payment Card and Third Party Network Transactions." Form 1099-K shows the monthly and annual amount paid to the merchant in a calendar year by customers using some type of payment card or third-party network, if the amount paid to the merchant exceeds $20,000 in that calendar year.

The third group of documents begins with a fax cover sheet that appears to be an altered copy of the one that is part of the first group, with "4JR Enterprises" stricken out and "High Five" written in in a style very similar to the handwriting style of R. Rabadi. The attached pages relate to High Five Enterprises, but while the altered cover sheet purports to attach 20 pages, only 4 of 14 pages are attached. The transcript text indicates that appellant provided only 4 of 10 pages for 2011 and 4 of 13 pages for 2012.

- Approximately 2,600 pages of what appellant describes as bank statements for all 18 bank accounts used by the Rabadi entities for the years 2011 and 2012, and what purports to be a summary of deposits shown in the bank statements. These statements show many deposits, checks and other withdrawals, inter-account transfers, and overdraft fees. The summary shows an accurate 2011 total for at least one account, but the 2011 total for at least one other account is significantly less than the totals deposits shown in the statements.[20]
- An analysis prepared by appellant that purports to calculate what appellant describes as "a 27.2 [percent] cash to 72.79 [percent] credit card ratio" (cash to credit ratio). Appellant begins its analysis by calculating what it characterized as its total 2011 sales revenue, including tax, of $31,860,648.[21] Appellant then subtracts what purports to be 2011 electronic payments totaling $25,046,267 shown by the 1099-Ks, to calculate cash purchases during 2011 totaling $6,814,381 ($31,860,648 - $25,046,267). Appellant must have then divided the cash payment amount by the electronic payment amount to calculate the cash to credit ratio. Appellant's analysis finally concludes that "This seems excessive for a gas station where most persons are paying with a card at the pump, especially since no single station had a cash sale incentive."[22]

[20] The summary shows a total of $7,207,638 for one account, but the total shown by the statements is almost $11 million more than that amount.

[21] As discussed below, appellant's numbers are not borne out by the evidence.

[22] There is nothing in OTA's record regarding cash sale incentives.

- Fourteen essentially identical declarations signed by employees or former employees of the Rabadi entities, all indicating that A. Rabadi seldom came to the business locations and was more of a passive or absentee owner.

24. A. Rabadi testified at the hearing to the following:

- The witness was married with three minor children when he went through a difficult divorce that was finalized near the end of 2008. He shared custody of the children. The witness claims to have lost interest in his business, apparently due to the problems with his marriage and the divorce.
- The witness stated that he would rarely go to the business locations, and when he did go, he would only stay for a few minutes.
- The witness indicated that he continued to make major decisions, such as when to close unprofitable locations, but he relied on employees, including his sister, and his outside bookkeeper to see to the routine management, record keeping, and tax reporting.
- Each Rabadi entity had more than one bank account.

25. R. Rabadi testified at the hearing to the following:

- R. Rabadi, who is A. Rabadi's sister and appellant's employee, handled routine day-to-day management of the business, including accurately documenting sales, maintaining business records, supervising personnel, and working with J. Humphrey to accurately reports taxes due. The witness has had no formal education or training in sales and use tax matters.
- Appellant used a POS system at its service stations and minimarts. A sales summary was created at the end of each shift and provided to the witness. Invoices or other evidence of purchases delivered were also provided to the witness. The witness provided sales summaries, purchase invoices, bank statements, and cancelled checks to J. Humphrey.
- Since before the liability period, J. Humphrey has prepared and filed all of appellant's tax returns, including both income tax returns and SUTRs.[23] J. Humphrey had direct access to respondent's website and to at least one of

[23] As of the date of the hearing in this appeal, J. Humphrey remained appellant's bookkeeper.

appellant's bank accounts, which enabled him to file returns and make payments directly to respondent.

- There were frequent transfers of money between the various business accounts to cover anticipated withdrawals for expenses and other things.
- J. Humphrey asked the witness to retrieve the voluminous business records that had accumulated in his office. A friend of the witness proposed that they rent a storage facility in which to store their records. The friend decided to hire a company to destroy his records. The friend gave the record-destruction company access to the storage facility but failed to properly supervise the process. As a result, appellant's records were also destroyed.
- One or more fuel vendors that also provided merchant services for credit cards would deduct or offset amounts owed to them for fuel deliveries from amounts owed to appellant for credit purchases.[24] As a result, amounts deposited directly into appellant's accounts for merchant services during a particular period may be thousands of dollars less than credit card purchases during the same period.

DISCUSSION

Issue 1: Are adjustments to the disputed measures of unreported taxable sales warranted?

California imposes sales tax on a retailer's gross receipts from the retail sale of tangible personal property in this state 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.) 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).)

Normally, in an appeal to OTA, respondent has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Talavera*, 2020-OTA-022P.) Once

[24] By "merchant services," this Opinion means credit and debit card processing services. The merchant services provider processes the credit transactions and issues periodic payments (net of any processing fee) to the retailer.

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.[25] (*Ibid*.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid*.)

In this case, the only records provided by appellant for the original audit were its federal income tax returns for 2013, 2014, and 2015, and sales summary reports for the period August 29, 2016, through September 30, 2016 (entirely outside of the liability period). No other books and records, such as cash register tapes, sales journals, general ledgers, financial statements, purchase journals, purchase invoices, or bank statements were provided for the liability period.

Generally, respondent prefers to determine the accuracy of reported amounts using a direct audit methodology.[26] However, respondent is authorized to determine a liability on the basis of any information in its possession (R&TC, § 6481; *Appeal of Amaya*, 2021-OTA-328P); and if a taxpayer's records are insufficient for a direct audit methodology (or if the provided records are deemed unreliable), it becomes necessary for respondent to compute the taxpayer's sales using an indirect audit methodology. (R&TC, § 6481, *Appeal of Las Playas #10, Inc.*, 2021-OTA-204P.) Here, the evidence clearly shows that appellant failed to provide business records that were adequate for a sales and use tax audit. Therefore, respondent's decision to employ an alternative, indirect audit methodology was appropriate.

OTA has examined the methodology employed by respondent to estimate appellant's taxable sales, and finds that the methodology was rationally designed to determine a reasonable estimate. Respondent used reliable prepaid sales tax data to calculate appellant's purchases of gasoline and diesel fuel. Respondent's reliance on OPIS data, the method it used to adjust that data to estimate the selling prices of mid-grade and premium gasoline, and respondent's reliance on appellant's own sales summary reports to determine the ratios of the various gasoline grades to total gasoline sales were reasonable and rational. Finally, respondent correctly included

[25] While this shifting of the burden may seem contrary to the requirement that respondent prove fraud by clear and convincing evidence, it is not. As will be discussed below under Issue 2, respondent has the burden of proving fraud by clear and convincing evidence, but the usual presumptions regarding respondent's determination of an amount of tax due still apply. (*Appeals of Jafari and Corona Motors, Inc.*, 2023-OTA-401P.)

[26] A direct audit method is one that enables respondent 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 methodology based on complete and accurate business records is generally the most accurate.

certain federal taxes and deleted the state sales tax from the pump price of gasoline and the state sales tax and the state diesel fuel excise tax from the pump price of diesel to calculate the measures of tax.[27] (See R&TC, § 6012(a)(4); Cal. Code Regs., tit. 18, § 1598(c)(1),(2).) Based on the foregoing, OTA finds that respondent's estimate that appellant's gasoline and diesel fuel sales during the liability period totaled $140,683,398 and $1,235,486, respectively, was reasonable and rational. The burden of proving otherwise thus shifts to appellant.

Appellant makes several arguments relevant to this issue. It argues that it was unable to provide adequate business records, though no fault of its own, due to the carelessness of the friend who allowed the records to be destroyed. Appellant contends that the quarterly average gasoline selling prices computed by respondent using OPIS information are inaccurate because by using quarterly average selling prices, respondent failed to properly consider price fluctuation within each quarter.[28] Additionally, appellant objects to the small sample (appellant's sales reports for the period August 29, 2016, through September 30, 2016) respondent used to compute ratios of sales of each grade of gasoline, arguing that if appellant actually sold more regular gasoline and less premium gasoline than the amounts computed from the sample, then the audited weighted average gasoline selling prices would be much lower, which could result in a substantial reduction to appellant's liability.

Appellant also argues that the audit was flawed, in part due to respondent's failure to use a second indirect audit methodology to verify the results of the first. Appellant asserts that either of two alternative methodologies, a bank deposit analysis or what appellant refers to as a "cursory expenditure analysis," would lead to more accurate measures. Finally, appellant argues that two things make it unlikely that appellant had unreported cash available: appellant would not have allowed itself to incur so many overdraft fees if it had unreported cash to cover all checks and other withdrawals; and neither A. Rabadi nor R. Rabadi could have hidden or disposed of such huge sums of money without triggering a report to tax or other authorities or being otherwise apparent through a cursory examination of their lifestyles.

[27] Appellant briefly raised the question of whether excise tax was properly included in the taxable measure for gasoline and diesel fuel but did not elaborate or argue the point, which is why the question is addressed summarily here.

[28] Appellant argued that there would have been increased fuel sales when prices decreased or were low, and decreased fuel sales when the prices increased or were high.

Regarding appellant's failure to maintain and provide adequate business records, the evidence shows that such records existed at some point in the past. Having been involved in several audits in the past, A. Rabadi and J. Humphrey, at least, understood that detailed records, such as those that were readily available from appellant's POS system, would enable J. Humphrey to prepare and file accurate SUTRs and would also have enabled respondent to conduct a direct audit to verify the accuracy of appellant's SUTRs. Appellant did not provide adequate business records. The consequences of appellant's failure to maintain and provide adequate business records correctly fall on appellant, who had the legal obligation and the ability to maintain and provide them. Those consequences include the use of an indirect audit methodology and the resulting estimate of taxable sales, and the difficulty of proving a more accurate result. OTA rejects appellant's argument, at least implied, that appellant should not be held responsible for its failure to provide adequate records.

Appellant's argument that the quarterly weighted average gasoline selling prices calculated by respondent could be wrong is speculative. There is no evidence that appellant's sales volume was price dependent. Accordingly, OTA finds this argument unpersuasive.

There is also no evidence to support appellant's assertion that the test period for determining the ratio of sales of the various gasoline grades to total gasoline sales was not fairly representative. Respondent used the records that appellant provided, and OTA has already found that analysis reasonable and rational. Appellant has not shown a more accurate way to determine these ratios. Therefore, this argument is also unpersuasive.

Appellant cites section 0407.05 of respondent's Audit Manual (the Audit Manual) to support an argument that in determining whether the audit results were reasonable, respondent should have compared the results of a second indirect audit method, such as a bank deposit analysis, with the results of its primary audit method.[29] The implication is that respondent's determination is unreliable because the audit did not include a second methodology to verify the reasonableness of the audit results. Although the Audit Manual can be a useful resource to which OTA may look for assistance interpreting, or determining the weight to be given to, audit findings, it does not constitute legal authority. (See *Yamaha Corp. of Am. v. State Bd. of Equalization* (1998) 19 Cal. 4th 1, 25; *Appeal of Micelle Laboratories, Inc.*, 2020-OTA-290P.)

[29] Appellant cites to section 0407.10, but the referenced language is in section 0407.05.

Section 0407.05 of the Audit Manual recommends that when it is necessary to conduct an audit using an indirect methodology, the auditor should use two or more such methodologies to estimate the sales, "comparing the results of one method against the results of another, if the auditor has enough information is available to do so."[30] This appears to be a recommendation to respondent's audit staff to test the reasonableness of the results of the first methodology against the results of a second indirect methodology. It does not limit OTA's authority to conclude that a determination based on an indirect audit is reasonable and rational, even when a second methodology is not employed. Furthermore, the evidence here indicates that respondent did not have enough reliable information during the audit to employ a second methodology. OTA has already found that respondent met its initial burden of showing that its determination was reasonable and rational. This argument does not establish a basis for changing that finding.

Based on the evidence, OTA finds that appellant has not established an error in respondent's analysis. Nevertheless, if appellant is able to prove a more accurate measure of tax, an adjustment would be warranted.

Appellant's argument that a bank deposit analysis would lead to a more accurate result is not supported by the evidence. The evidence does not contain a bank deposit analysis, at least not one that compares cash and credit card deposits to reported amounts with appropriate adjustments for sales tax reimbursement included, non-sales revenue, non-taxable sales, and the like.[31] Instead, appellant provided over 2,600 pages of bank records and its own very broad, inaccurate,[32] and not particularly helpful analyses of total deposits and various other data.

For example, in one analysis referred to in Factual Finding 23, fifth bullet point, above, appellant purports to calculate a 27.2 percent cash to 72.79 percent credit card ratio and then appears to opine that the ratio of cash purchases is too high. This analysis does not support appellant's position. First, cash-to-credit and credit-to-cash ratios are not particularly helpful in

[30] Section 0407.05 of the Audit Manual states, in part, that "When it is determined that a taxpayer's records are such that sales cannot be verified by a direct audit methodology, the auditor must estimate the sales from whatever information is available. The following sources of information and procedures have been found useful in determining probable sales: Bank deposits (section 0405.25); Gross profit and net worth analysis test (section 0406.40); Income tax returns (section 0406.50); Purchases plus mark-up (section 0407.10). If enough information is available to do so, the auditor should use two or more of these methods to estimate the sales, comparing the results of one method against the results of another."

[31] See footnote 18, above.

[32] See the fourth bullet point under Factual Finding 23, above.

this context. Typically, when OTA examines cash or credit purchases, it is the ratio of those purchases to total purchases that is revealing, and appellant's conclusion confirms that appellant is arguing that the credit purchase ratio should have been higher. Using appellant's numbers, the credit purchase ratio actually was higher than that calculated by appellant. It was 78.61 percent.[33] In other words, the documents indicate that almost 79 percent of appellant's customers paid using a credit or debit card, and appellant believes that ratio should be higher because most customers pay at the pump. OTA finds that this analysis does not prove either an error in respondent's analysis or a more accurate measure.[34]

In another analysis, appellant purports to calculate a $2,623,250 difference between total revenue collected by the three Rabadi entities during 2012 of $55,199,997 and total deposits by them of $52,576,727. Appellant draws two conclusions from these numbers. It concludes that: (1) if the determination (following the reaudit) was accurate, there would have to be at least $55,199,997 in deposits and some of that would represent sales tax reimbursement, nontaxable sales and perhaps other sources properly excluded from a measure of taxable sales; and (2) the determination is at least $2,623,250 too high for 2012[35] because deposits total only $52,576,727. This analysis, which appellant refers to as a bank deposit analysis, is also unpersuasive. When gross receipts[36] exceed total deposits, OTA cannot conclude on that basis alone that audited sales are overstated. Unless it can be reliably confirmed that the retailer has deposited all gross receipts in the accounts analyzed, the difference could be due to the retailer using cash for other purposes instead of depositing it in the bank. It is difficult, if not impossible, to trace unrecorded cash. In short, appellant has not proved a more accurate liability.

Appellant's remaining arguments are based on the proposition that appellant could not have siphoned significant cash from the businesses because it would have used that money to cover checks and other withdrawals for which there were insufficient funds, triggering overdraft fees, and because the owner and the manager do not live lavish lifestyles and would not have

[33] Conversely, the cash purchase ratio was 21.39 percent.

[34] OTA's experience with similar audits leads it to believe that a 78.61 percent credit purchase ratio is in the high range of what one should expect. An unreasonably high credit purchase ratio could be the result of a retailer failing to report cash sales.

[35] Appellant's evidence states "2011," but given that all the data refers to 2012, OTA infers that this reference is an error.

[36] In this context, OTA is using the term to refer to audited total sales, including sales tax reimbursement.

been able to hide or dispose of significant amount of cash without triggering a report to the IRS or otherwise alerting authorities. These arguments are speculative. Overdraft fees are evidence of insufficient funds in a particular account at a particular moment in time. There are myriad reasons why an account may be overdrawn. Overdraft fees do not establish the account owner's lack of funds.

There is no credible evidence in the record concerning the lifestyles of those who may have benefited from the determined understatement, including A. Rabadi, his ex-wife, his children, or others who may depend upon him for support. Furthermore, speculation about whether someone could have managed to hide or dispose of millions of dollars over a period of more than six years does not constitute proof of an error in respondent's analysis or a more accurate measure of tax, which is what appellant is required to prove if it is to prevail on this issue.

In summary, the audit and reaudit were well designed to estimate appellant's taxable sales. Furthermore, they were well executed and did, in fact, determine a reasonable estimate of appellant's taxable sales. The burden of proving otherwise shifted to appellant, and appellant failed to prove an error in respondent's analysis or a more accurate measure. On the basis of the evidence, OTA finds that appellant has failed to prove facts that would warrant any adjustment to the disputed measures of unreported taxable sales.

Issue 2: Does clear and convincing evidence establish fraud sufficient to avoid the bar of the statute of limitations and to support the imposition of the fraud penalty?

Respondent imposes a penalty of 25 percent of the unpaid tax if it is determined that any part of the deficiency for which a deficiency determination is made is due to fraud. (R&TC, § 6485; Cal. Code Regs., tit. 18, § 1703(c)(3)(C); see also *State Bd. of Equalization v. Renovizor's Inc.* (9th Cir. 2002) 282 F.3d 1233, 1240-1241.) 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 after the last day of the calendar month following the quarterly period for which the amount is

proposed to be determined or within three years after the return is filed, whichever period expires the later.[37]

The plain language of R&TC section 6487(a) indicates that the three-year statute of limitations applies to each reporting period covered by a determination. As previously stated, the NOD that is the subject of this appeal was not filed within the three-year statute of limitations insofar as it determined liabilities for the period January 1, 2010, through March 31, 2013, which encompasses 13 quarterly reporting periods. Thus, in order for the NOD to be deemed timely for those reporting periods, the evidence must prove that appellant intended to defraud the state or evade the payment of tax for at least some portion of each quarterly reporting period from 1Q10 through 1Q13.[38] (*Appeal of Senehi*, 2023-OTA-446P.)

Fraud is intentional wrongdoing on the part of the taxpayer with the specific intent to avoid a tax known to be owed. (*Appeal of Delgado*, 2018-OTA-200P.) Fraud must be established by clear and convincing evidence. (Cal. Code Regs., tit. 18, § 1703(c)(3)(C); *Appeal of ISIF Madfish, Inc.*, 2019-OTA-292P.) However, this does not mean that respondent must prove every contested fact by clear and convincing evidence. (*Appeals of Jafari and Corona Motors, Inc.*, 2023-OTA-401P.) Rather, OTA looks to the totality of the evidence to determine whether respondent has met its burden. (*Ibid.*)

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. (*Appeal of Delgado, supra*.) 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, provide a sufficient basis for a finding of fraud. (*Appeal of ISIF Madfish, Inc., supra*.) Other "badges" of fraud include inadequate records, implausible or inconsistent explanations of behavior, concealment of assets, failure to cooperate with tax authorities, and a taxpayer's lack of credibility. (*Ibid.*)

The evidence shows that appellant included sales tax reimbursement in the pump price for gasoline and diesel fuel and that sales tax reimbursement was added to the price of other tangible personal property sold though the minimarts. It also shows that A. Rabadi, R. Rabadi,

[37] Appellant filed quarterly. R&TC section 6487(b) contains a similar limitations period for taxpayers who file annually.

[38] Respondent has not argued otherwise.

and J. Humphrey all understood that the Sales and Use Tax Law required appellant to maintain and provide to respondent complete and accurate business records and to file accurate SUTRs. Appellant had detailed business records. The evidence shows that these records were in the possession of R. Rabadi and J. Humphrey. J. Humphrey has been the bookkeeper and tax preparer for the Rabadi entities for many years, had represented several other businesses owned by A. Rabadi for years before that, had participated in several tax audits of those businesses, and had, in addition, handled tax reporting for 40 to 60 other clients. This indicates that J. Humphrey is the person most knowledgeable regarding how appellant's SUTRs were prepared. Yet, appellant failed to call J. Humphrey or any other witness who could explain appellant's reporting methodology.

Above, OTA has found that the results of the reaudit will stand. For the liability period, appellant collected from its customers, but did not remit to the state, sales tax reimbursement totaling $1,719,248. For the first quarter of the liability period, customers paid appellant over $124,000 to reimburse appellant for sales tax that appellant never paid. That was the highest amount of tax kept by appellant for any quarter during the liability period. Quarter after quarter, appellant failed to report and instead kept tens of thousands of dollars that should have been paid to the state.

Additionally, for the 24 quarters of the liability period, appellant substantially underreported taxable sales in every quarter. The unreported measure totaled $43,119,665 for the liability period. The minimum underreported measure was $791,182 for 4Q10. The highest unreported measure was $3,235,158 for 3Q11. Twenty-one of the 25 quarterly understatements were over $1 million. In 2010 alone, the earliest year at issue, appellant understated its taxable measure by $4.2 million. Appellant's owner and manager deny knowledge of the understatements. OTA finds this incredible, and concludes that the sheer volume and consistency of appellant's underreporting are persuasive evidence of fraud.

All of these amounts would have been apparent from the records which passed through the hands of R. Rabadi and J. Humphrey, at least. No special tax expertise was needed when appellant's own records showed substantial amounts of unreported taxable sales. Yet, appellant has not offered a credible explanation of how reported amounts were calculated. Two of the three people who should have been able to do that, a manager who claims to have been little more than a conduit of detailed sales records from the sources (POS system, vendors, etc.) to

J. Humphrey, and an owner who claims to know nothing of substance regarding sales and use tax compliance, did not credibly explain how they failed to notice: (1) why appellant had so much more money in the bank than it reported in sales; and (2) what happened to the large sums of money that, at least according to appellant's records, should have been deposited into the bank account(s) but were not. According to appellant, J. Humphrey should have been able answer these questions; but appellant did offer any testimony from J. Humphrey and did not explain its failure to do so.

R. Rabadi made inconsistent statements about what happened to appellant's business records. Respondent notified one of the Rabadi entities on April 28, 2016, that it was about to be audited. Less than two weeks later, J. Humphrey, apparently the only person who can explain how appellant calculated reported amounts, informed respondent that he would not be involved in the audit. On several occasions thereafter, R. Rabadi informed respondent that business records would be provided. On July 25, 2016, R. Rabadi informed respondent that she provided monthly POS reports to J. Humphrey, who used those to prepare appellant's SUTRs. It was not until August 2, 2016, that R. Rabadi informed respondent that the records had been accidentally shredded.[39] Just a few weeks later, on August 25, 2016, R. Rabadi told respondent that she discarded POS reports after she made notes from them, that the reports could not be reproduced, and that respondent would not have been able to understand her notes. However, at the hearing, R. Rabadi again stated, this time in testimony, that POS reports were produced at the end of each shift and that these reports were given to J. Humphrey. R. Rabadi testified that she gave respondent a copy of the invoice from the shredding company, but there is no supporting evidence regarding that anywhere in OTA's record. OTA finds that detailed business records were within appellant's control and that appellant has not provided a credible explanation for its failure to submit such records to respondent and to OTA.

A taxpayer's failure to produce evidence that is within its control gives rise to a presumption that such evidence, if provided, would be unfavorable to the taxpayer's case. (*Appeal of Morosky*, 2019-OTA-312P.) Appellant failed to provide business records and a key witness, J. Humphrey. It also appears from the evidence that appellant misrepresented evidence

[39] Even after this communication, R. Rabadi was telling another of respondent's auditors that business records would be provided.

that it submitted to OTA and respondent. OTA concludes that these failures are evidence of appellant's failure to cooperate with taxing authorities, which is indicative of fraud.

As already discussed in connection with Issue 1, above, appellant disagrees with the amount of the underreporting, arguing that it was considerably less than the reaudit indicates. OTA has already dealt with that argument and need not discuss it further. Appellant also attempts to distinguish the instant facts from those discussed in other tax cases where fraud was found, including nonprecedential opinions issued by OTA; but the thrust of appellant's argument consists of the following:

- A. Rabadi was an absentee owner who had little to do with the business, and nothing to do with tax reporting, during the liability period. He entrusted all day-to-day operations to his employees, including his sister, and entrusted the maintenance of appellant's books and other aspects of sales and use tax compliance to J. Humphrey.
- R. Rabadi had no tax expertise and had nothing to do with tax reporting during the liability period other than delivering to J. Humphrey all documents over which she had control and that he might need to maintain appellant's books.
- J. Humphrey may not have been aware of the facts that some merchant service providers were also product vendors who offset accounts receivable from amounts due to appellant for credit purchases, and this simple or perhaps even negligent mistake could account for at least some of the underreporting.
- J. Humphrey was an independent third party (i.e., not appellant's employee), who maintained appellant's books and handled all tax filings.
- To the extent J. Humphrey's possible failure to notice the offsets do not account for the entire understatement, what remained must have been due to cash sales because all credit sales are evidenced by 1099-Ks that have been provided to respondent.
- If A. Rabadi had the cash, appellant would not have incurred so many overdraft fees.

OTA is not persuaded by appellant's argument that no fraud should be found here because the instant facts do not establish conduct as egregious as that analyzed in other tax fraud cases. Every appeal is decided based on the facts shown by the evidence. Arguments that

demonstrate a clear basis for distinguishing, and, therefore, not following a *precedential* case can be persuasive; but appellant essentially argues that OTA should treat certain factual elements of these earlier opinions, such as error ratios, as de facto thresholds under which fraud should not be found. That argument has no sound legal basis.

A. Rabadi's argument that he was an absentee owner and not involved in the business, so he could not have been personally involved in any fraud, misses the mark. A. Rabadi is not the appellant. OTA must determine whether there is clear and convincing evidence of fraud *by appellant*. Although it is true that corporations can only act through their officers, agents, and employees (see *Kight v. CashCall, Inc.* (2011) 200 Cal.App.4th 1377, 1392), a finding of fraud here does not require OTA to find that any particular officer, agent, or employee participated in the filing of fraudulent SUTRs.

Appellant's argument that its delegation of tax responsibility to an outside bookkeeper further insulates it, its owner, and its employee (R. Rabadi) against respondent's fraud allegation lacks a sound legal foundation. As just stated, a corporation can only act through its officers, agents, and employees. The knowledge of J. Humphrey is properly imputed to appellant. (Civ. Code, § 2332; *O'Riordan v. Federal Kemper Life Assurance* (2005) 36 Cal.4th 281, 288.) Furthermore, acts or omissions of J. Humphrey in connection with appellant's sales and use tax compliance were the acts of appellant, even if J. Humphrey willfully failed to comply with the Sales and Use Tax Law. (Civ. Code, § 2338; see also *Alexander Shokai, Inc. v. Commissioner* (9th Cir. 1994) 34 F.3d 1480, 1488, and *Ruidoso Racing Ass'n, Inc. v. Commissioner* (10th Cir. 1973) 476 F.2d 502, 506.)

Absentee or not, A. Rabadi was the owner of appellant. Appellant does not argue that an agent or employee embezzled funds, and there is nothing in OTA's record that would support such a finding. If someone profited from the understatement other than appellant, that person was A. Rabadi or someone who A. Rabadi allowed to profit. For OTA's purposes, though, these questions do not need to be answered. There was a large understatement, and the evidence indicates that every return filed by appellant for the liability period was fraudulent.

HOLDINGS

1. Adjustments to the disputed measures of unreported taxable sales are not warranted.
2. There is clear and convincing evidence of fraud sufficient to avoid the bar of the statute of limitations and to support the imposition of the fraud penalty.

DISPOSITION

Respondent's action in reducing the measure of tax to $43,119,665,[40] and otherwise denying the petition, is sustained.

DocuSigned by:
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Michael F. Geary
Administrative Law Judge

We concur:

DocuSigned by:
DC88A60D8C3E442...
Keith T. Long
Administrative Law Judge

DocuSigned by:
CB1F7DA37831416...
Josh Lambert
Administrative Law Judge

Date Issued: 5/20/2024

[40] The measure of tax in the reaudit consists of unreported gasoline sales of $37,695,284, unreported diesel fuel sales of $261,558, unreported taxable minimart sales of $4,586,949, unreported propane sales of $434,800, and unreported taxable cigarette rebates of $141,074.