OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	OTA Case No. 21067999
	CDTFA Case ID: 126-044
F & B ASSOCIATES, INC.,	
dba Best Beverage Catering	

OPINION

Representing the Parties:

For Appellant:	Kevan McLaughlin, Attorney
For Respondent:	Jarrett Noble, Attorney Chad Bacchus, Attorney Jason Parker, Chief of Headquarters Operations
For Office of Tax Appeals:	Deborah Cumins, Business Taxes Specialist III

N. RALSTON, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, F & B Associates, Inc. (appellant) appeals a March 2, 2020 decision issued by the California Department of Tax and Fee Administration (respondent)[1] partially denying appellant's timely petition for redetermination of a Notice of Determination (NOD) issued on May 19, 2016. The NOD is for tax of $4,850,919.79, plus applicable interest, and a fraud penalty of $1,212,730.50 for the period October 1, 2008, through September 30, 2013[2] (liability period).

There have been five reaudits since respondent issued the NOD. In the most recent reaudit, respondent reduced the audited taxable measure by $1,413,482 to $30,301,282.

[1] Sales and use taxes were formerly administered by the State Board of Equalization (board). In 2017, functions of the board relevant to this case were transferred to respondent. (Gov. Code, § 15570.22.) For ease of reference, when this Opinion refers to events that occurred before July 1, 2017, "respondent" shall refer to the board.

[2] The NOD was timely. It was issued within the three-year limitation period for the second quarter of 2013 (2Q13) and 3Q13. (See R&TC, §§ 6487(a).) In addition, before expiration of any period at issue, appellant signed a series of consecutive waivers, the last of which allowed respondent until October 31, 2016, to file an NOD for the period October 1, 2008, through March 31, 2013. (See R&TC, § 6488.)

Office of Tax Appeals (OTA) Administrative Law Judges Natasha Ralston, Michael F. Geary, and Andrew J. Kwee[3] held an oral hearing for this matter in Cerritos, California, on June 8, 2023. At the conclusion of the hearing, OTA held the record open to allow the parties to submit additional briefing. OTA closed the record in this matter on June 18, 2024.

ISSUES

1. Whether appellant has established that further adjustment to the audited amount of unreported taxable sales is warranted.
2. Whether appellant has established that further adjustment to the audited amount of disallowed claimed nontaxable sales is warranted.
3. Whether appellant has established that further adjustment to the audited cost of equipment purchases subject to use tax is warranted.
4. Whether respondent has established fraud by clear and convincing evidence; and, if not, whether OTA has the authority to impose the negligence penalty in lieu of the fraud penalty.

FACTUAL FINDINGS

1. Appellant is a corporation that has operated a food and beverage service since February 1995. Appellant provides services such as organizing concessions at various events, managing in-house food and beverage programs, and offering catering services. Appellant has multiple business locations, both in California and in other states.
2. Respondent previously audited appellant for the period October 1, 2005, through September 30th, 2008. Ultimately, respondent determined a deficiency measure exceeding $10 million, which included unreported taxable sales, disallowed claimed sales for resale, and unremitted sales tax reimbursement collected from customers.
3. In the prior audit, respondent also found that the deficiency resulted from fraud. It applied the 25 percent penalty for fraud for the period October 1, 2005, through March 31, 2007, and a 40 percent penalty for appellant's failure to timely remit sales tax reimbursement that it had collected (40 percent penalty) for the period April 1, 2007, through September 30, 2008. However, respondent's Appeals Division relieved

[3] Judge Wong replaced Judge Kwee. OTA notified the parties of this substitution, and they did not object.

appellant of these penalties for the prior audit period in a Decision and Recommendation (D&R) because appellant's understatements may have resulted from a misunderstanding of the Sales and Use Tax Law, in conjunction with some carelessness in recordkeeping.[4]

4. The current audit commenced on June 4, 2012.

5. During the liability period, appellant reported: total sales of $98,820,404; nontaxable sales for resale of $17,862,930; nontaxable charges for labor of $2,387,939; exempt sales in interstate or foreign commerce of $4,659,895; "other" nontaxable charges of $7,462,970; and taxable sales of $66,446,670.

6. For audit, appellant provided general ledgers, sales journals, sales tax accrual reports, federal income tax returns, financial statements, and some sales and purchase invoices. Appellant did not provide sales tax worksheets identifying the sales it regarded as taxable or any information explaining which accounts in the General Ledger (GL) represented taxable sales.

7. Respondent found that the total sales recorded in appellant's GL exceeded total sales reported on sales and use tax returns (SUTRs) for the period January 1, 2010, through September 30, 2013, by $24,631,411. Respondent noted that $8,432,569 of the difference represented recorded exempt sales, but it could not readily identify the source of the remaining difference of $16,198,842.

8. Respondent compared appellant's recorded sales tax accrued of $6,847,268 for the liability period to reported tax of $5,692,200 to establish a difference of $1,155,068. Since appellant had not collected tax reimbursement with respect to all its taxable sales, respondent did not use this difference to establish the audited understatement of reported taxable sales.

9. Respondent reviewed the accounts recorded in appellant's GL and scheduled the total sales recorded in accounts that appeared to represent taxable sales, based on the account name.[5]

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[4] When respondent issued the D&R, it believed that the 40 percent penalty was a fraud penalty that required proof by clear and convincing evidence. OTA later determined in an unrelated appeal that the 40 percent penalty is not a fraud penalty, and that respondent can sustain it on the basis of proof by a preponderance of evidence. (*Appeal of ISIF Madfish, Inc.*, 2019-OTA-292P.)

[5] The following are some examples of accounts that appeared to represent taxable sales: 5006 – Café Fresh Deli; 5012 – TI Bar Grill Non-alcohol; 5050 – Other Partys; and 5055 – Catering/Concession.

10. Using the total sales recorded under those accounts, respondent compiled what it considered to be total recorded taxable sales of $120,844,175 for the liability period. Respondent compared that amount to reported taxable sales of $66,446,670 to compute an understatement of $54,397,504. (Audit item 1.)

11. Respondent noted a sales account labeled "5050 - Other Party Revenue" (other party account) with recorded transactions totaling $81,260,166 for the liability period. Appellant did not report these amounts on its SUTRs. Respondent used the third quarter of 2013 (3Q13) as a test period and, after accounting for any sales that were not subject to tax (e.g., sales for resale, sales that occurred out-of-state, and commissions paid to appellant that were not part of appellant's sales of tangible personal property), found that sales of $2,005,710 out of the total of $8,783,725 in the sample period were nontaxable sales. Respondent calculated a nontaxable sales percentage of 22.83 percent, which, when applied to appellant's total sales in the other party account, resulted in nontaxable sales of $18,555,264.

12. In its review of appellant's general ledger, respondent found that appellant had recorded some sales as "Catering sales – nontaxable." The comments on audit workpaper Schedule 12C-1 state that respondent did not find any differences between the types of sales recorded as "Catering sales – nontaxable" and "Catering sales – taxable." Respondent scheduled as taxable the transactions recorded as "Catering sales – nontaxable" for which appellant did not provide resale certificates or evidence that the sales had occurred outside California. The total of disallowed claimed or netted[6] nontaxable sales was $1,015,946. (Audit item 2.)

13. During the initial audit, respondent examined appellant's fixed asset purchases as recorded in its GLs.[7] Respondent found fixed asset purchases of $920,917 during the liability period. Respondent initially found that appellant purchased equipment for use in California during the liability period at a cost of $920,917, but appellant did not pay California sales or use tax in connection with those purchases. (Audit item 3.)

[6] Appellant did not report all its recorded sales on its SUTRs, and it appeared that some nontaxable sales were not reported. Thus, the evidence indicates that appellant claimed some nontaxable sales and netted others.

[7] Respondent only reviewed large purchases because it determined that reviewing smaller purchases would not be cost effective for this audit.

14. Respondent observed that appellant collected sales tax reimbursement, which indicated knowledge of the requirement to report and pay the tax. In addition, respondent observed that the computed amounts of sales tax for large events demonstrated that appellant was aware of the charges that were subject to tax (sales of tangible personal property) and those that were not subject to tax (charges for services). As a result, respondent concluded that appellant had sufficient knowledge of the application of tax to correctly record and report its taxable sales.

15. Respondent concluded that the deficiency measured by $56,334,367[8] was the result of fraud. Respondent determined that the fraud penalty was warranted because there were substantial differences between gross receipts reported for federal income tax purposes and those reported for sales and use tax purposes in each of the years 2009 through 2012 ($6.5 million, $5 million, $8 million, and $5 million, respectively, rounded). Respondent also noted material amounts of accrued sales tax that were recorded but not reported throughout the liability period ($92,000 in 4Q08; $60,000 in 2009; $318,000 in 2010; $240,000 in 2011; and $492,000 for the first three quarters of 2013, also rounded).

16. On May 19, 2016, respondent issued the NOD for tax of $4,850,919.79, applicable interest, and a fraud penalty of $1,212,730.50.

17. On May 25, 2016, appellant filed a petition for redetermination of the NOD.

18. On July 2, 2019, respondent held an appeals conference. During the appeal with respondent, appellant provided additional supporting documentation, including resale certificates, seller's permits, sales invoices, purchase invoices, contracts, and service agreements. Appellant asserted that the sales recorded in its other party account included additional nontaxable transactions. Appellant conducted a test of sales recorded in that account for 3Q13. Respondent reviewed appellant's test and the supporting evidence and computed a percentage of nontaxable sales for other party account of 22.83 percent (rounded). Using that percentage, respondent computed that $18,555,264 of the sales recorded in other party account for the liability period were nontaxable sales. In addition to that adjustment, respondent concluded that it should use the figures recorded in the GL, rather than the figures shown in the financial statements, to establish the audited

[8] $54,397,504 recorded but not reported taxable sales + $1,015,946 disallowed nontaxable sales + $920,917 purchases subject to use tax = $56,334,367.

understatements.[9] Respondent recommended reducing the audited difference between recorded and reported taxable sales by $19,987,733 to $34,409,771 ($54,397,504 - $19,987,733).

19. Respondent did not adjust the audited amounts of recorded taxable sales for commissions that appellant received from vendors at concerts and other events. The commissions represented a percentage of the vendors' sales. Respondent found that the commissions were paid to appellant in exchange for appellant's coordination of the various events. Since food and beverages were sold at those events, respondent concluded that the commissions were subject to tax.[10]

20. Respondent also recommended reducing audit item 3 by $641,238, from $920,917 to $279,679.

21. On March 2, 2020, respondent issued its decision partially denying appellant's petition for redetermination.

22. Following respondent's issuance of the decision, but before this appeal to OTA, appellant provided additional information, and respondent conducted second, third and fourth[11] reaudits to remove additional transactions totaling $3,361,047 from the measure for audit item 1 that were not part of appellant's taxable sales of food and beverages.

23. Based on this additional information, respondent removed from appellant's other party account all sales that were identified as vendor concessions as well as sales for resale to one vendor.[12] These adjustments increased the nontaxable sales percentage for 3Q13 to 26.97 percent ($2,379,809 ÷ $8,823,732). After applying this percentage to the liability

[9] Respondent had previously used the figures in the financial statements, which were higher than the figures in the GL. Although appellant had not explained the differences between the two reports, respondent conceded "that the general ledger breakdown might be the more correct of the two reports."

[10] As noted below, in the second reaudit, respondent reversed its position on commissions.

[11] Respondent also reduced the taxable measure on the rental of appellant's point of sale system by $83,300.

[12] Appellant provided documentation to show that for certain events appellant sold beverages but hired other vendors to provide food. These other vendors collected sales tax reimbursement measured by the retail sales price to the customer and appellant collected a percentage of the vendor's sales as a commission fee. Thus, respondent concluded that the vendors and not appellant were the retailers or the food and liable for the tax based on these sales. Respondent also conceded that appellant's commission fees for the vendor's sales were not part of its sales of beverages and thus were not subject to tax. Respondent also allowed sales to one vendor as nontaxable sales for resale based on its determination that the property was more likely than not resold.

period, the total taxable sales for appellant's other party account were reduced to $59,343,855.

24. Respondent then added the $59,343,855 in taxable sales to appellant's other recorded taxable sales to establish total audited taxable sales of $97,029,472, which, when compared to reported taxable sales of $66,446,670, resulted in a deficiency measure for unreported taxable sales of $30,582,801.

25. On October 12, 2021, respondent's Investigations Division seized records from appellant's three business locations pursuant to a search warrant. According to appellant, those records remained in the exclusive possession of respondent when OTA conducted the oral hearing in this matter on June 8, 2023.

26. On June 20, 2023, OTA issued post hearing orders, which

- granted appellant's request to submit a closing brief to summarize the arguments and evidence, while specifically limiting the closing brief to a discussion of evidence already admitted and arguments already made in this appeal, as well as such additional evidence and/or arguments OTA specifically requests, as described below;
- directed the parties to identify all documents seized from appellant and not returned prior to the hearing;
- directed appellant to state how, if at all, respondent's seizure and retention of evidence impaired appellant's ability to meet its burden of proof, including a description of the warranted adjustments appellant would have been able to establish and the evidence it would relied upon to prove its entitlement to same;[13]
- directed appellant to detail its attempts to obtain the seized record prior to the hearing; and
- directed the parties to state their positions regarding whether OTA has the authority to impose a negligence penalty in lieu of the fraud penalty if OTA concludes that respondent has not carried its burden of proving fraud by clear and convincing evidence. OTA advised the parties against submitting additional

[13] The Order asked the parties to provide a list of the records seized and to explain whether respondent's seizure of the records affected the present matter before OTA, and if so, to describe how the present matter was affected.

evidence or argument outside of that requested in OTA's post hearing orders without first obtaining permission to submit additional evidence from OTA.

27. After the hearing before OTA, respondent conducted a fifth reaudit. During this reaudit, respondent removed additional transactions from audit item 1 to account for additional sales for resale, which reduced audit item 1 by $1,414,482, from $30,582,801 to $29,169,319, with a corresponding total deficiency measure of $30,301,282.
28. Both parties submitted additional briefing in response to OTA's order.
29. Respondent's brief, submitted on October 23, 2023, contained additional exhibits labeled N, O, P, and Q.
30. In its post hearing brief, appellant objected to respondent's submission of exhibits P and Q as untimely. Exhibit P is titled "Prior Sales and Use Tax Returns," and Exhibit Q is titled "Assignment Contact History for Prior Audit."
31. On March 8, 2024, OTA issued an order holding the record open to allow respondent to provide appellant with the seized documents, legible copies of documents, or access to the documents so that appellant could make copies.
32. Via email dated, June 10, 2024, appellant advised OTA that it no longer requests return of the documents seized by respondent, and asked OTA to make its findings based on the documents and evidence already provided.
33. OTA closed the record in this matter on June 10, 2024.

DISCUSSION

Post Hearing Evidentiary Issue

Generally, the submission of appellant's reply brief will end the briefing process, including submission of evidence, unless OTA determines additional briefing is necessary. (Cal. Code Regs., tit. 18 § 30303(d).) Upon concluding an oral hearing proceeding, the Panel will determine the date when the official hearing record closes and no further evidence or argument will be accepted from the parties. (Cal. Code Regs., tit. 18 § 30412(a).)

Here, OTA issued post hearing orders stating that the parties were not to submit additional evidence or arguments, other than that specifically requested by OTA. OTA has reviewed respondent's additional exhibits and has determined that exhibits N and O shall be

admitted as both parties agree to their admission to the record. Exhibits P and Q shall not be admitted to the record as they are untimely and outside the scope of OTA's post hearing orders.

Issue 1: Whether appellant has established that further adjustment to the audited amount of unreported taxable sales is 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.) 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).)

A retailer's gross receipts are presumed subject to tax, and the burden of proving that a sale of tangible personal property is not at retail is upon the retailer unless the retailer takes in good faith a resale certificate from the customer stating that the property is purchased for resale. (R&TC, §§ 6091, 6092; Cal. Code Regs., tit. 18, § 1668(a).) If a seller fails to timely obtain a resale certificate in proper form, the seller will be relieved of liability for the tax only where it shows that the property at issue: (1) was in fact resold by the customer and was not used by the customer for any purpose other than retention, demonstration, or display while holding it for sale in the regular course of business; (2) is being held for resale by the customer and has not been used for any purpose other than retention, demonstration, or display, while being held for sale in the regular course of business; or (3) was consumed by a customer who reported the tax due directly to respondent on its SUTRs or paid the tax due to respondent pursuant to an assessment or an audit. (Reg. Cal. Code Regs., tit. 18, § 1668(e).) 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).)

If 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*.)

In this case, respondent identified significant discrepancies in appellant's records. For example, the total sales in appellant's GL exceeded total sales reported on SUTRs for the period January 1, 2010, through September 30, 2013, by $24,631,411, only $8,432,569 of which were recorded as exempt sales. Given that the audit of appellant for the immediately preceding period established unreported taxable sales of $18,216,176, it was not unreasonable for respondent to conclude that reported taxable sales were probably understated. Without sales tax worksheets, respondent could not determine what sales appellant deemed taxable and reported as such. Under the circumstances, it was reasonable for respondent to simply rely on the various GL account titles to identify the accounts that represented taxable sales. Therefore, it was reasonable for respondent to utilize the names of various GL accounts to identify the accounts that represented taxable sales.

Regarding both its establishment of recorded taxable sales from GL account descriptions and its review of recorded nontaxable sales, respondent has made adjustments to reflect all documentation provided by appellant after the original audit. Respondent has also used its own records regarding appellant's customers to identify sales made to purchasers who were more likely than not to have been purchasing the products for resale.

For purchases subject to use tax, respondent initially scheduled the purchases for which appellant did not provide evidence that it had paid sales tax reimbursement to vendors or had paid use tax on its returns. After the audit, appellant provided the requisite evidence for some of the purchases, and respondent has made all warranted adjustments, based on the evidence provided.

Accordingly, OTA finds that respondent has shown that its determination was reasonable and rational. Therefore, appellant has the burden to establish that further adjustment is warranted to each of the audit items.

Appellant asserts that further adjustments are warranted. Appellant specifically argues that the adjustment for nontaxable sales recorded in other party account should be increased. Appellant provided consolidated quarterly reports from appellant's San Francisco office, which appellant contends summarize event-level information provided by appellant's vendors for

specific events. Appellant contends that this information recorded by appellant's San Francisco office was reported in the other party account and are a more accurate representation of appellant's actual sales during the liability period. Using this information, appellant calculates a 9.33 percent error rate, which appellant contends would result in no deficiency if this error rate were applied to the entire liability period. Furthermore, at the hearing, appellant provided quarterly sales summaries, which it contends more accurately represent its actual sales during the liability period. Appellant also provided testimony from several witnesses, which corroborated the sales summaries.

It is appellant's responsibility to provide complete records. In this case, appellant did provide some records, but it did not provide records that clearly delineated the sales that appellant reported as taxable sales. Additionally, appellant does not dispute that the other party account included some taxable sales; rather, appellant argues that the account contained additional nontaxable sales. However, appellant has not provided sufficient evidence to show that specific sales should have been classified as nontaxable sales but were not so classified. Appellant offers only unsupported assertions, which are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Talavera*, *supra.*)

Appellant also conducted a test of 3Q13, and respondent reviewed appellant's test. Appellant has not provided evidence that 3Q13, which appellant selected as a test period, was representative of the remainder of the liability period. Moreover, appellant has neither conducted a test of additional periods to show that the percentage of nontaxable sales recorded under other party account was higher in other periods nor offered evidence that a test of one quarter is not sufficiently long to establish a representative percentage to be applied to the remainder of the liability period.

At the hearing, appellant provided testimony stating that respondent had seized many of appellant's records needed to refute respondent's audit. However, respondent seized these documents on October 12, 2021. The audit commenced on June 4, 2012, approximately nine years before the records were seized. Between the date the audit commenced and the date respondent seized the records, appellant had multiple opportunities to provide supporting records. Nevertheless, after the hearing, OTA held the record open to allow appellant time to obtain the seized records. Due to the associated cost, appellant declined to obtain the records and provide them to OTA. Thus, OTA has no basis on which to make any additional adjustments.

Issue 2: Whether appellant has established that further adjustment to the audited amount of disallowed claimed nontaxable sales is warranted.

Respondent reviewed sales that appellant had recorded as nontaxable catering sales. Respondent has explained that it initially reviewed the supporting documentation (e.g., contracts) for sales recorded as taxable catering sales and those recorded as nontaxable catering sales. Respondent was not able to discern any difference between the two types of transactions. Accordingly, respondent regarded sales recorded as "nontaxable catering sales" to be taxable transactions unless appellant provided evidence that a sale was exempt or excluded from taxation by statute, such as resale certificates or contracts to show that the sale occurred outside California.

As stated previously, a retailer's gross receipts are presumed to be subject to tax, and the retailer is responsible for documenting that a sale is exempt or excluded from taxation. (R&TC, §§ 6091, 6092; Cal. Code Regs., tit. 18, § 1668(a).) Respondent has adjusted the disallowed claimed and netted nontaxable sales for all transactions for which appellant provided the requisite evidence.

With respect to its review of sales recorded as "Catering sales - nontaxable," respondent noted that there was no discernible difference between the types of sales recorded as "taxable catering sales" and those recorded as "Catering sales - nontaxable." Further, appellant initially did not provide evidence, such as resale certificates or contracts showing that the events occurred out of state, to document that recorded nontaxable catering sales were not subject to tax. Thus, it was reasonable for respondent to disallow those claimed nontaxable sales.

In its June 24, 2022 brief, appellant asserts that there are additional nontaxable sales that have not been identified as nontaxable in the audit. Appellant first states that food and drinks are susceptible to spoilage. Appellant also argued that sales to vendors were all sales for resale, as evidenced by copies of sellers' permits that appellant provided. Appellant also asserted that the vendors were not concessionaires and, therefore, it was not required to take resale certificates from them. Respondent concurred with appellant's assertion that those vendors were not concessionaires. However, respondent did not concede that sellers' permits are sufficient to show that appellant's sales to those vendors were sales for resale. At the hearing, appellant provided testimony from several employees, all of whom testified that the various vendors had

seller's permits and resale certificates. Furthermore, at the hearing, various witnesses testified that all vendors at appellant's events had seller's permits and resale certificates.

As stated above, to document that a sale is a sale for resale, the retailer must provide a timely resale certificate or provide other specific evidence to rebut the presumption of taxability.[14] (Cal. Code Regs., tit. 18, § 1668.) Appellant's assertion that a resale certificate is only required if appellant's customers were operating as concessionaires has no statutory or regulatory support.

The evidence indicates that appellant made both taxable and nontaxable sales of food and beverages. The nontaxable sales are sales that appellant made to vendors who then sold the food and beverages to their customers would be nontaxable sales for resale if appellant took a timely resale certificate.[15] Respondent has made adjustments for claimed sales for resale for which appellant has provided the required evidence. In its June 24, 2022 brief, under Item 3, "San Diego Non-Taxable Catering," appellant lists five sales that it contends were either out-of-state transactions or a sales for resale. Respondent allowed claimed sales for resale when respondent's records indicated that the purchaser had a seller's permit and was in the business of selling the same kind of goods.

Appellant has not provided documentation, and appellant's unsupported assertions are not sufficient to satisfy its burden of proof that adjustments are warranted. (See *Appeal of Talavera*, *supra*.) OTA finds that appellant has not shown that further adjustments are warranted to the audited amount of disallowed claimed nontaxable sales.

[14] In general, the evidence must establish that the tangible personal property: 1) was resold by the purchaser without any intervening use; 2) is being held in resale inventory; or 3) was consumed by the purchaser with tax paid to respondent either on an SUTR or pursuant to an audit. (See Cal. Code Regs., tit. 18, § 1668(e).)

[15] Appellant also made sales outside California that are not subject to tax in this state. Those sales are not at issue in this discussion regarding sales for resale.

Issue 3: Whether appellant has established that further adjustment to the audited cost of equipment purchases subject to use tax is warranted.[16]

California imposes use tax on the storage, use, or other consumption in California of tangible personal property purchased from a retailer for storage, use, or other consumption in this state, unless the use is specifically exempt by statute. (R&TC, § 6201.) A person who stores, uses, or otherwise consumes tangible personal property in this state is liable for the tax, and liability for use tax is not extinguished until the tax has been paid to the state; or the person is given a receipt for the tax from a retailer engaged in business in this state, and who is authorized by the Board to collect the tax. (R&TC, § 6202(a).) With respect to purchases subject to use tax, respondent initially scheduled the purchases for which appellant did not provide evidence that it had paid sales tax reimbursement to vendors or had paid use tax on its returns. After the audit, appellant provided the requisite evidence for some of the purchases, and respondent has made all warranted adjustments, based on the evidence provided.

A lease is a temporary transfer of possession and control of tangible personal property for consideration. (Cal. Code Regs., tit. 18, § 1660(a)(1).) A "lease" includes a rental, hire, license, and "a contract under which a person secures for a consideration the temporary use of tangible personal property which … is operated by, or under the direction and control of, the person or his or her employees." (R&TC, § 6006.3; Cal. Code Regs. tit. 18, § 1660(a)(1).) Generally, a lease of tangible personal property in California is a continuing sale and a continuing purchase, unless the property is leased in substantially the same form as acquired by the lessor, and the lessor made a timely election to pay tax or tax reimbursement on the purchase price of the property. (R&TC, §§ 6006(g)(5), 6006.1, 6010(e), 6010.1; Cal. Code Regs., tit. 18, §§ 1660(b)(1)(E), (b)(2).) When a lease does constitute a continuing sale and purchase, and the lessor fails to make a timely election to pay tax or tax reimbursement on the purchase price, then use tax generally applies, measured by the rental receipts, which the lessor must collect from the lessee at the time rentals are paid and must remit to respondent. (Cal. Code Regs., tit. 18, § 1600(c)(1).)

[16] Appellant initially raised this issue in its opening brief. OTA issued its Minutes and Orders on May 16, 2023, noting that there were only three issues in dispute: 1.) Whether appellant has established that further adjustment is warranted to the audited amount of unreported taxable sales, 2.) Whether appellant has established that further adjustment is warranted to the audited amount of disallowed claimed nontaxable sales, and 3.) Whether respondent had proved fraud by clear and convincing evidence. At the hearing, the parties further confirmed that these were the only three issues in dispute. However, appellant re-added this issue in its post-hearing brief. Respondent had the opportunity to address this issue in its opening brief and its post-hearing brief. Thus, out of an abundance of caution, OTA will address this issue here.

Here, appellant had made several purchases of equipment that it used in its business. Respondent initially scheduled all recorded purchases for which appellant did not provide evidence that it had either paid sales tax reimbursement to its vendors or paid use tax on its SUTRs. After the audit, appellant provided evidence showing that several of its purchases were not subject to use tax. In the first reaudit, the amount of purchases subject to use tax was reduced from $920,917 to $279,679.

In its June 24, 2022 brief, appellant confirmed that only one purchase remains in dispute, a purchase from PFC, a credit card processing company. Appellant provided a service agreement with PFC, dated in 2012 (the month is illegible), which states that the monthly payment is $2,975.[17] Respondent regarded the entire amount as a rental of equipment subject to use tax. There is a handwritten note on the service agreement that states, "48 payments of $2,975 … $142,800," and the amount included as taxable in the audit was $142,800. In its September 30, 2022 brief, respondent explains that the audited amount subject to tax has been reduced to $59,500, which represents the lease payments made during the liability period.

Appellant refers to a statement on the service agreements with PFC, "The program allows you to rent high-quality equipment…. In addition, you will have unlimited access to debt collection services by Professional Finance Company…, and other valuable payment processing services such as QuickBooks integration." Appellant asserts that debt collection services and payment processing services are not subject to tax and, on that basis, argues that a portion of the rental payments should not be subject to use tax.

Respondent responds that the monthly rental is a lump sum amount, and the available evidence does not itemize the amount charged for services. Respondent asserts, therefore, that the entire amount is subject to use tax.

Appellant cites *Dell, Inc. v. Superior Court* (2008) 159 Cal.App.4th 911 (*Dell*) to support its position. In that case, the court held that a sale for computers and service contracts sold at the same time for a single undifferentiated price on the invoice was only taxable with respect to the computer. Appellant asserts that its contract with PFC was similar to those considered by the

[17] The transaction here is a lease of equipment. As explained above, the lease payments are subject to use tax unless the lessor has made a timely election to pay tax or tax reimbursement on the cost of the tangible personal property. There is no evidence that PFC made such a timely election, and the business is located in Colorado. Accordingly, the available evidence indicates that use tax is due on the lease receipts, and appellant has not argued otherwise.

court in *Dell* and argues that respondent should apportion part of its monthly rental charge to PFC to nontaxable services.

Appellant misconstrues *Dell*. The services at issue in *Dell* were optional service contracts[18] that were not part of the sale of the computers (and therefore nontaxable), and the lump-sum sales price did not render the optional services taxable. (*Dell, Inc. v. Superior Court*, *supra*, at pp. 929-931.) Thus, the court ruled that the portion of the lump-sum charge attributable to nontaxable services could be apportioned out of the measure of tax. (*Dell, Inc. v. Superior Court*, *supra,* at p. 936.) In other words, services included as a part of the taxable sale of tangible personal property do not become nontaxable just because the charge for those services can be readily apportioned from the sale of tangible personal property. Likewise, services that are not part of the sale of tangible personal property (i.e., optional services) are nontaxable (R&TC, § 6012(b)(1)), regardless of whether they are separately stated or included as a part of a lump-sum contract (unless some other authority requires that they be separately stated, such as with transportation charges (Cal. Code Regs., tit. 18, § 1628(a)). (*Dell, Inc. v. Superior Court*, *supra*, at pp. 929-931).

Here, in contrast to the facts in *Dell*, PFC's services are not itemized separately from the equipment rentals. There is no indication that PFC offered customers the option of changing the configuration of the agreement, for example by deleting the services and paying only for the equipment rental or by purchasing the services without the equipment rentals. Therefore, PFC's services appear to be mandatory and part of the sale of the tangible personal property, and therefore taxable.

Accordingly, OTA finds that appellant has not shown that further adjustments are warranted to the audited cost of purchases subject to use tax.

Issue 4: Whether respondent has established fraud by clear and convincing evidence; if not, whether OTA has the authority to reduce the fraud penalty to a negligence penalty.

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."

[18] The service contracts were optional because the purchaser could select whether or not to purchase the service contract at the time of purchasing a computer; and the charge for the computer was reduced by a specified sum if the customer declined the service contract. (*Dell, Inc. v. Superior Court*, *supra,* at p. 931.)

Fraud or intent to evade must be established by clear and convincing evidence. (Cal. Code Regs., tit. 18, § 1703(c)(3)(C).) The burden is on respondent. (See *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.)[19] 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 a 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.*, *supra* [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*.)

Appellant argues that the respondent has not established fraud by clear and convincing evidence. At the hearing, appellant provided testimony that appellant had retained Mr. Dressel a competent and licensed California CPA with no history of any disciplinary matters. Appellant's witnesses asserted that the prior audit overstated the deficiency, but due to a serious illness, Mr. Dressel was unable to protest the prior audit. Appellant's witnesses also testified that appellant's owner, Mr. Alton, did not handle sales and use tax matters and that there was no evidence that Mr. Alton committed fraud. OTA notes that Mr. Alton is not the taxpayer, but rather, the corporation is appellant. Thus, OTA need not find that any particular owner, agent, or employee was guilty of fraud in order to find that the fraud penalty was properly imposed against the corporation. Appellant further asserts that respondent made numerous concessions to the audit that reduced the unreported taxable sales by millions of dollars.

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. In the prior audit, for the period October 1, 2005, through September 30, 2008, respondent established an understatement of reported taxable sales

[19] Because there are few cases that discuss R&TC section 6485, OTA considers, by analogy, the standards that apply under Internal Revenue Code section 6633, the federal income tax fraud penalty.

including sales of approximately $7.5 million for which tax was accrued but not reported. In the prior audit, respondent also found claimed sales for resale for which appellant did not provide documentation. In other words, the errors in the prior audit were similar to the errors identified in this audit. Respondent ultimately relieved the fraud penalty in the prior audit, apparently concluding that at least some of the deficiency might have been due to a misunderstanding of the Sales and Use Tax Law and not due to an intent to evade the payment of tax. Yet, appellant continued to report far fewer taxable sales than it recorded, and it continued to remit far less sales tax than it accrued. There comes a point at which a taxpayer's continuing failures can be reasonably deemed to be intentional. Appellant reached that point when these same errors came to light during the prior audit.

Further, appellant had considerable business experience, including the aforementioned audit, and kept books and records demonstrating that it properly charged and collected tax reimbursement for some sales and that it even calculated the tax due from its own sales during various festivals which it failed to report. Thus, appellant was aware of the Sales and Use Tax Law and how to properly calculate and report tax due. Nevertheless, even after five reaudits, the audited error rate is 46 percent, and appellant failed to report almost a third of its taxable sales. Appellant has not satisfactorily explained the deficiency, which is substantial both in amount and in the rate of understatement. Appellant also did not maintain its records in a way that taxable and nontaxable sales were readily identified. Respondent established a difference between recorded and reported taxable sales of approximately $29 million for the liability period. The differences occurred consistently throughout the liability period and ranged from about $500,000 per quarter to over $5 million per quarter. The only explanation appellant has offered regarding these differences is that some of the sales are not subject to tax. However, appellant has not provided the requisite documentation, even though it should have been fully aware of the necessity to document nontaxable sales because of the prior audit, in which respondent disallowed over $5 million of claimed sales for resale. Appellant has not shown that the difference between recorded and reported taxable sales that establishes the substantial understatements were due to honest mistake or negligence. OTA finds that the only reasonable

explanation for the substantial discrepancies between recorded and reported taxable sales, is a willful attempt to evade the payment of tax. (*Bradford*, *supra*.).[20]

HOLDINGS

1. Appellant has failed to establish that further adjustment is warranted to the audited amount of unreported taxable sales.
2. Appellant has failed to establish that further adjustment is warranted to the audited amount of disallowed claimed nontaxable sales.
3. Appellant has failed to establish that further adjustment is warranted to the audited cost of equipment purchases subject to use tax.
4. Respondent has established fraud by clear and convincing evidence.

DISPOSITION

Respondent's action is sustained.

Signed by:
Natasha Ralston
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Natasha Ralston
Administrative Law Judge

We concur:

DocuSigned by:
Michael F Geary
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Michael F. Geary
Administrative Law Judge

DocuSigned by:
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Andrew Wong
Administrative Law Judge

Date Issued: 9/23/2024

[20] As OTA has found respondent has established by clear and convincing evidence that the fraud penalty was property imposed, the issue of whether OTA has the authority to reduce the fraud penalty to a negligence penalty is now moot.