OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **SOUTHERN CAFÉ AT 2000 MACARTHUR LLC**	OTA Case No. 220811148 CDTFA Case ID: 2-187-771

OPINION

Representing the Parties:

For Appellant: P. Bell, LLC Member
Jeanne Robertson, Representative

For Respondent: Courtney Daniels, Attorney

For the Office of Tax Appeals: Craig Okihara, Business Taxes Specialist III

A. WONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6901, Southern Café at 2000 MacArthur LLC (appellant) appeals respondent California Department of Tax and Fee Administration's (CDTFA's) decision denying appellant's claim for refund.[1] Appellant submitted the claim for refund with respect to payments made towards liabilities in a Notice of Determination (NOD) that CDTFA timely issued to appellant on May 1, 2018, for the period April 1, 2013, through December 31, 2016 (liability period).[2] CDTFA issued the NOD to appellant for the following liabilities: (1) a tax liability of $222,165.86, plus applicable interest, for the liability period; (2) a 25 percent fraud penalty of $1,635.69 for the second quarter of 2013 (2Q13) and 4Q13; and (3) a 40 percent penalty of $86,249.24 for failing to timely remit collected sales tax reimbursement for 3Q13 and the period January 1, 2014,

[1] The State Board of Equalization (BOE) formerly administered sales and use taxes. On July 1, 2017, BOE administrative functions relevant to this case transferred to CDTFA. (Gov. Code, § 15570.22.) For ease of reference, when this Opinion refers to events that occurred before July 1, 2017, "CDTFA" shall refer to BOE.

[2] CDTFA timely issued the NOD because appellant waived the otherwise applicable three-year statute of limitations and extended CDTFA's NOD-issuance deadline to July 31, 2018. (See R&TC, §§ 6487(a), 6488.)

through December 31, 2016.[3] CDTFA based the tax liability of $222,165.86 on unreported taxable sales and mandatory tips totaling $2,384,621. Appellant paid its tax liability in full along with some of the accrued interest.

During CDTFA's internal appeals process, appellant indicated that it only disputed unreported taxable sales and mandatory tips for 2016 (totaling $1,235,191) and conceded that the statute of limitations largely barred its claim for refund except for payments totaling $26,198.93, which appellant made on or after December 2, 2019. For its part, CDTFA recommended relieving interest accrued for the period September 1, 2016, through November 30, 2016.

Appellant waived the right to an oral hearing, so the Office of Tax Appeals (OTA) decides this matter based on the written record pursuant to California Code of Regulations, title 18, (Regulation) section 30209(a).

ISSUES

1. Whether the amount of unreported taxable sales and mandatory tips should be reduced.
2. Whether CDTFA established fraud by clear and convincing evidence.
3. Whether CDTFA properly imposed the 40 percent penalty; if so, whether relief of the penalty is warranted.
4. Whether additional relief of interest is warranted.

FACTUAL FINDINGS

1. Appellant is a California limited liability company (LLC) that organized in October 2012. On November 1, 2012, appellant's sole member, P. Bell, registered for a sole proprietorship account with CDTFA. In February 2013, appellant began operating a restaurant in Oakland, California. For most of the liability period, appellant's sales were reported to CDTFA under P. Bell's sole proprietorship account.
2. On or about January 1, 2016, another restaurant began operating in Antioch, California. The Antioch restaurant's sales for the 1Q16 were reported to CDTFA under P. Bell's sole proprietorship account.

[3] The NOD also reflected the following five payments: (1) $798.18 on December 31, 2015; (2) $1,166 on January 22, 2016; (3) $5,000 on August 17, 2017; (4) $5,000 on September 22, 2017; and (5) $2,450.22 on February 1, 2018. Additionally, appellant failed to pay the NOD when it became due and payable (i.e., final) on May 31, 2018, so CDTFA added a "finality penalty" of $20,775.03 per R&TC section 6565. On June 2, 2020, CDTFA relieved appellant of the finality penalty, so the Office of Tax Appeals will not discuss this penalty further.

3. An LLC named "Southern Café at 400 G Street, LLC" organized on March 21, 2016, and subsequently operated the Antioch restaurant.
4. On April 20, 2016, CDTFA sent P. Bell an audit engagement letter, which identified a three-year audit period of January 1, 2013, through December 31, 2015 (audit period). Subsequently, CDTFA added 1Q16 to the audit period because the statute of limitations for issuing a determination with respect to 1Q13 expired.
5. Upon audit, CDTFA determined that appellant (not P. Bell) had operated both the Oakland restaurant and the Antioch restaurant (the latter for 1Q16 only), which were improperly registered under P. Bell's sole proprietorship account. CDTFA closed P. Bell's sole proprietorship account and issued two separate seller's permits: (a) one to appellant for the Oakland restaurant (with an effective start date of April 1, 2013); and (b) one to Southern Café at 400 G Street, LLC for the Antioch restaurant (with an effective state date of April 1, 2016).
6. Sales reported under P. Bell's now-closed sole proprietorship account (including the Antioch restaurant's 1Q16 sales) transferred to appellant's account. CDTFA also extended the audit period to December 31, 2016, and continued its audit as an audit of appellant rather than P. Bell.
7. For the liability period, appellant reported the following on its sales and use tax returns (SUTRs): total sales of $775,714; deductions for sales tax reimbursement included in reported total sales of $3,931 in 4Q15 and 1Q16; and taxable sales of $771,783.

Books & Records, Audit Method, and Audit Results

8. For the audit, appellant provided the following books and records: point-of-sale (POS) system sales reports for the period July 1, 2013, through December 31, 2016; and bank statements for the period January 1, 2015, through April 30, 2016. CDTFA obtained from third parties appellant's 2014 federal income tax return (FITR) and Form 1099-Ks for the liability period.[4] Appellant did not provide other requested books and records for the liability period such as the following: sales tax worksheets; FITRs for any years besides 2014; purchase journals; or source documentation (e.g., cash register tapes, guest checks, or merchandise purchase invoices).

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

9. Appellant used POS system sales reports to report sales on its SUTRs. Per the POS system sales reports, appellant added sales tax reimbursement on all sales. However, CDTFA could not verify how appellant compiled reported sales on its SUTRs.

10. Based on its preliminary analyses of the books and records provided for audit, CDTFA found a lower-than-expected book markup,[5] as well as discrepancies between reported total sales on its SUTRs and both gross receipts, reported on the 2014 FITR, and bank deposits.[6] CDTFA concluded that appellant's reported taxable sales were understated, and the best evidence of appellant's taxable sales was the POS system sales reports.

11. Using the POS system sales reports, CDTFA compiled total recorded sales taxes of $288,952 for the liability period, composed of the following: recorded sales taxes of $265,777 for the Oakland restaurant for the liability period and $23,175 for the Antioch restaurant for 1Q16.[7] For each quarter in the liability period, CDTFA divided recorded sales taxes by the applicable sales tax rate and computed taxable sales of $3,110,310 ($2,852,810 for the Oakland restaurant + $257,500 for the Antioch restaurant) for the liability period.

12. Using the POS system sales reports, CDTFA also compiled the following recorded taxable sales: $2,855,401 for the Oakland restaurant for the liability period,[8] and $257,538 for the Antioch restaurant for 1Q16.

13. For each quarter in the liability period, CDTFA used taxable sales calculated from either recorded sales taxes or recorded taxable sales (whichever was greater) to compute

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[5] "Markup" is the amount by which a retailer increases the cost of merchandise to set the retail price. For example, if the retailer's cost is $0.70 and it charges customers $1.00, the markup is $0.30. The formula for determining the markup percentage is markup amount ÷ cost. In this example, the markup percentage is 42.86 percent (0.30 ÷ 0.70 = 0.4286). A "book markup" (sometimes referred to as an "achieved markup") is a markup calculated from the retailer's records.

[6] Bank deposits are not gross receipts. (R&TC, § 6012(a).) However, where, as here, a retailer is engaged in the business of making retail sales of tangible personal property, the retailer's bank deposits, net of deposits from non-sale or nontaxable transactions, are evidence of gross receipts from the retail sale of tangible personal property, which CDTFA can use to determine audited taxable sales when sales cannot be accurately established using a direct approach because of a lack of adequate records.

[7] Because POS system sales data was not available for the Oakland restaurant for 2Q13, CDTFA used the average recorded sales taxes for 3Q13 and 4Q13 as an estimate for 2Q13.

[8] Because POS system sales data was not available for the Oakland restaurant for 2Q13, CDTFA used the average recorded taxable sales for 3Q13 and 4Q13 as an estimate for 2Q13.

audited taxable sales of $2,861,741 for the Oakland restaurant for the liability period and $257,538 for the Antioch restaurant for 1Q16.

14. For 4Q13, audited taxable sales were less than reported taxable sales. Because appellant did not provide evidence that it had overreported its sales in 4Q13, CDTFA accepted reported taxable sales for that quarter.

15. Upon comparison to reported taxable sales, CDTFA computed unreported taxable sales of $2,100,881 for the Oakland restaurant for the liability period and $247,400 for the Antioch restaurant for 1Q16.[9] Thus, CDTFA calculated unreported taxable sales totaling $2,348,281 ($2,100,881 + $247,400) for the liability period.

16. From the POS system sales reports, CDTFA noted that appellant charged taxable mandatory tips but did not report them. CDTFA compiled recorded taxable mandatory tips of $36,341 for the liability period. Thus, CDTFA established a separate measure for unreported taxable mandatory tips of $36,341.[10]

17. For the liability period, CDTFA determined that appellant had unreported taxable sales and mandatory tips totaling $2,384,621 (rounded) ($2,348,281 + $36,341).

18. Per a penalty memorandum dated March 12, 2018, CDTFA also imposed on appellant a 25 percent fraud penalty of $1,635.69 for 2Q13 and 4Q13 based on the following findings:

    a. Appellant knew of the requirements of the Sales and Use Tax Law because it had maintained an active seller's permit, kept accurate records of its taxable sales, and properly computed and collected sales tax reimbursement from its customers.

    b. Appellant consistently underreported taxable sales and mandatory tips totaling $2,384,621 (rounded), which translated to an error percentage of 308.98 percent (underreporting of $2,384,621 ÷ reported taxable sales of $771,783).

[9] Unreported taxable sales of $2,100,881 for the Oakland restaurant consisted of the following amounts for each quarter in the liability period (excluding 4Q13 for which CDTFA accepted reported taxable sales): $70,839 for 2Q13; $70,672 for 3Q13; $22,503 for 1Q14; $108,000 for 2Q14; $58,183 for 3Q14; $137,857 for 4Q14; $147,690 for 1Q15; $154,196 for 2Q15; $145,177 for 3Q15; $214,599 for 4Q15; $250,796 for 1Q16; $237,614 for 2Q16; $286,925 for 3Q16; and $195,830 for 4Q16.

[10] Unreported mandatory tips of $36,341 consisted of the following amounts for each quarter in the liability period (except for 2Q13): $1,009 for 3Q13; $1,858 for 4Q13; $1,473 for 1Q14; $1,137 for 2Q14; $1,025 for 3Q14; $3,128 for 4Q14; $1,898 for 1Q15; $1,740 for 2Q15; $3,473 for 3Q15; $2,973 for 4Q15; $3,923 for 1Q16; $4,381 for 2Q16; $4,262 for 3Q16; and $4,060 for 4Q16.

c. Appellant's bookkeeper/manager/assistant had informed appellant's lone member, P. Bell, about the discrepancies between appellant's recorded and reported taxable sales, but P. Bell disregarded the discrepancies.

d. Appellant demonstrated the intent to evade paying tax because, despite the accuracy of its recordkeeping regarding taxable sales and collected sales tax reimbursement, appellant could not credibly explain its failure either to accurately report its taxable sales or to remit a substantial amount of collected sales tax reimbursement.

19. The penalty memorandum also noted that appellant's lone member, P. Bell, had set up a bank account in the name of "Southern Café at 2000 Macarthur," and, according to CDTFA, used this account to pay for expenses related to appellant's business.

20. Per the penalty memorandum, CDTFA also imposed upon appellant a 40 percent penalty of $86,249.24 for failing to remit collected sales tax reimbursement for 3Q13 and the period January 1, 2014, through December 31, 2016, based on the following findings:

a. Per its POS system sales reports, appellant recorded sales tax of $288,952 for the liability period but only reported sales tax of $66,716 for the same period, resulting in unremitted sales tax reimbursement totaling $222,236.

b. Unremitted sales tax reimbursement ranged from $3,599 to $46,052 per quarter (except for 4Q13 when it was $1,777) and averaged $4,939 per month for the liability period.

c. The ratio of unremitted sales tax reimbursement to total tax liability per quarter ranged from 10 percent to 32 percent (except for 4Q13 when the ratio was 5 percent) and averaged 26 percent per quarter for the liability period.[11]

21. On May 1, 2018, based on the above-mentioned audit, CDTFA timely issued the NOD to appellant.

22. Appellant did not appeal or pay the NOD within 30 days of its issuance, so the NOD became due and payable (i.e., final) on May 31, 2018.

23. After CDTFA issued the NOD, appellant made payments towards its liabilities. As of February 14, 2020, appellant had paid off the tax liability in full. CDTFA applied subsequent payments towards accrued interest.

[11] CDTFA did not apply the 40 percent penalty to 4Q13 because unremitted sales tax reimbursement for that quarter did not meet the applicable thresholds. And although unremitted sales tax reimbursement for 2Q13 did meet the applicable thresholds, appellant did not provide CDTFA with the POS system sales report for 2Q13, so CDTFA did not apply the 40 percent penalty to that quarter.

Claim for Refund, CDTFA Appeals Conference, Parties' Communications, and Decision

24. On June 2, 2020, appellant filed a claim for refund, which CDTFA denied.
25. Appellant appealed CDTFA's denial, initiating CDTFA's internal appeals process.
26. On August 11, 2021, CDTFA's Appeals Bureau held an appeals conference with appellant. At the appeals conference, appellant only disputed unreported taxable sales and tips totaling $1,235,191 for 2016 (including the Antioch restaurant's sales for 1Q16) out of an aggregate deficiency measure of $2,384,621 for the liability period. Appellant also conceded that the statute of limitations largely barred its claim for refund except with respect to payments totaling $26,198.93, which appellant made on or after December 2, 2019 (i.e., within six months of appellant's June 2, 2020 claim for refund).
27. Following the appeals conference, appellant communicated the following to the appeals conference holder via an email dated October 14, 2021: "[A]t the start of the appeals hearing you made it clear that you had no jurisdiction to offer any relief of penalty or interest after the taxes were paid in full. It was very disappointing and discouraging."
28. Via email dated October 15, 2021, the appeals conference holder provided the following response: "[A]t the appeals conference I questioned whether the scope of the claim for refund encompasses the two penalties and asked both parties questions relating to the issue. My inquiry during the appeals conference, to be clear, is not tantamount to a decision on the issue. To avoid further confusion—I reiterate that at this stage, I have not decided on any issues. Rather, I am gathering the evidence to issue a Decision." The appeals conference holder then requested a signed and dated request for relief of penalties and interest.
29. Appellant submitted the request for relief of penalties and interest on or about October 17, 2021. Subsequently, CDTFA conceded to relieving interest for the period September 1, 2016, through November 30, 2016.
30. CDTFA's Appeals Bureau issued its decision dated May 24, 2022, which ordered relief of interest per CDTFA's concession but otherwise denied appellant's claim for refund.
31. On July 15, 2022, CDTFA confirmed to appellant that interest had been reduced per the Appeals Bureau's decision and informed appellant of its option to either request that CDTFA reconsider its decision or appeal to OTA.
32. Appellant timely appealed to OTA.

DISCUSSION

Issue 1: Whether the amount of unreported taxable sales and mandatory tips should be reduced.

California imposes upon all retailers a sales tax measured by the 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, it is presumed that all gross receipts are subject to tax until the contrary is established. (R&TC, § 6091.)

Generally, tax applies to sales of meals or hot prepared food products furnished by restaurants. (R&TC, § 6359(a), (d); Cal. Code Regs., tit. 18, § (a)(2)(A).) A mandatory payment designated as a tip, gratuity, or service charge is included in taxable gross receipts. (Cal. Code Regs., tit. 18, § 1603(g), (h).)

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 CDTFA is not satisfied with the tax returns or the amount of tax required to be paid to the state by any person, CDTFA may compute and determine the amount required to be paid on the basis of any information within its possession or that may come into its possession. (R&TC, § 6481.)

In the case of an appeal, CDTFA has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Las Playas #10*, 2021-OTA-204P.) If CDTFA's determination is not reasonable and rational, then the determination should be rejected. (See *Appeal of Praxair, Inc.*, 2019-OTA-301P; see also *In re Renovizor's, Inc.* (9th Cir.) 282 F.3d 1233, 1237, fn. 1.) If CDTFA's determination is reasonable and rational, then the determination is presumed correct. (See *In re Renovizor's, Inc.*, *supra*, 282 F.3d at 1237, fn. 1; see also *Paine v. State Bd. of Equalization* (1982) 137 Cal.App.3d 438, 445 (*Paine*).) The burden of overcoming this presumption is on the taxpayer. (*Paine*, *supra*, 137 Cal.App.3d at p. 445.)

Generally, the appellant bears the burden of proof as to all issues of fact. (Cal. Code Regs., tit. 18, § 30219(a).) The standard of proof is by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(b).) That is, a taxpayer must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Appeal of AMG Care Collective*, 2020-OTA-173P.) Unsupported assertions are not sufficient to satisfy a

taxpayer's burden of proof. (*Appeal of Las Playas #10, Inc.*, *supra*.) To satisfy its burden of proof, a taxpayer must prove both that the tax assessment is incorrect and what the proper amount of tax should be. (*Appeal of AMG Care Collective*, *supra*.)

On appeal, appellant does not argue that CDTFA erred in calculating the audit liability. Rather, appellant first objects to CDTFA's inclusion of the Antioch restaurant's sales for 1Q16 in its determination of liabilities. Appellant also argues that the liability period should not have included the three-quarter period of April 1, 2016, through December 31, 2016, because this period exceeds the three-year audit period originally identified in CDTFA's audit engagement letter. Appellant contends that CDTFA was not authorized to perform an audit for a period greater than three years because the "rules of the audit" do not give the auditor the "right to pull additional records."

Here, CDTFA found that appellant operated the Antioch restaurant prior to the organization of Southern Café at 400 G Street, LLC on March 21, 2016, for three reasons. First, CDTFA found that the Antioch restaurant's sales for 1Q16, like the Oakland restaurant's sales for most of the liability period, were incorrectly reported under Mr. Bell's sole proprietorship seller's permit. Second, according to CDTFA's penalty memorandum, the expenses of both the Oakland restaurant and the Antioch restaurant were paid from a single business bank account in appellant's name. Third, both restaurants were listed on the Oakland restaurant's website (southerncafe2000.com). Thus, CDTFA concluded that appellant also operated the Antioch restaurant during 1Q16.

While this appeal was pending before OTA, OTA asked the parties to clarify who owned and operated the Antioch restaurant during 1Q16 and to provide any evidence or documentation supporting their answers. CDTFA's provided its response, which OTA summarized in the prior paragraph, along with supporting documentation, but appellant failed to reply. Appellant bears the burden of proof as to issues of fact, which includes who owned/operated the Antioch restaurant during 1Q16 (see Cal. Code Regs., tit. 18, § 30219(a).), but it has not supplied any evidence contradicting CDTFA's finding that appellant operated the Antioch restaurant during 1Q16. Accordingly, OTA concludes that CDTFA has met its minimal, initial burden to show that including the Antioch restaurant's sales for 1Q16 as part of appellant's audit liability was reasonable and rational, and further finds that appellant has failed to carry its burden of proving otherwise.

As for appellant's argument that the audit period is limited to three years by "the rules of the audit," appellant has not identified or cited to these alleged rules, and OTA is unaware of the existence of such rules. OTA notes that CDTFA's audits *generally* examine a taxpayer's

reporting for three-year intervals (i.e., 12 quarters), but CDTFA can modify or extend periods under audit. (See, e.g., *Appeal of Thomas Conglomerate*, 2021-OTA-030P [four-year audit period of January 1, 2004, through December 31, 2007].) Here, CDTFA initially selected appellant for a three-year audit period but ultimately extended the audit period through December 31, 2016. OTA is unaware of any restrictions on CDTFA's ability to modify or extend the liability period beyond the originally selected three-year audit period, except for the statute of limitations. In this regard, appellant signed waivers/extensions of the statute of limitations that ultimately extended the deadline for issuing an NOD for the 15-quarter liability period in this matter to July 31, 2018.[12] Thus, OTA finds that CDTFA timely issued the NOD for all periods under audit on May 1, 2018. Accordingly, OTA concludes that CDTFA's inclusion of the period April 1, 2016, through December 31, 2016, as part of the liability period was proper, and that appellant's argument that the liability period should be limited to three years is unpersuasive.

In summary, appellant has neither contested CDTFA's computation of appellant's audited taxable sales nor provided documentation or other evidence showing that including the Antioch restaurant's 1Q16 sales in appellant's audit liability and extending the audit period beyond three years was unreasonable or irrational. Because appellant failed to carry its burden of proof in this case, OTA concludes that the total amount of unreported taxable sales and mandatory tips should not be reduced.

Issue 2: Whether CDTFA established fraud by clear and convincing evidence.

CDTFA applied a 25 percent fraud penalty of $1,635.69 to the liability determination for the periods 2Q13 and 4Q13.

If any part of the deficiency for which a deficiency determination is made is due to fraud or an intent to evade the Sales and Use Tax Law or authorized rules and regulations, a penalty of 25 percent of the amount of the determination will be added thereto. (R&TC, § 6485.) Fraud is intentional wrongdoing on the part of the taxpayer with the specific intent to avoid a tax known to be owing. (*Appeal of Farrell*, 2023-OTA-095P.) CDTFA must establish fraud or intent to evade by clear and convincing evidence. (Cal. Code Regs., tit. 18, §§ 1703(c)(3)(C), 30219(c); *Appeals of Jafari and Corona Motors, Inc.*, 2023-OTA-401P.) Clear and convincing evidence requires that the evidence be so clear as to leave no substantial doubt (*Appeal of Treyzon*, 2023-OTA-399P) and leads to a firm belief or conviction that it is highly probable that the contention of fraud or intent to evade is true. (See *Appeals of Jafari and Corona Motors, Inc.*,

[12] See footnote 2, page 1.

supra.) The clear and convincing standard of proof is higher than proof by a preponderance of the evidence, but it does not require proof beyond a reasonable doubt. (*Ibid*.)

Direct evidence of a taxpayer's fraudulent intent or intent to evade the payment of taxes due is not required; fraud can be proven by circumstantial evidence. (*Appeal of Jafari and Corona Motors, Inc.*, *supra*.) The omission or understatement of reportable sales alone is not sufficient to support a fraud finding; however, repeated understatements in successive reporting periods, combined with other circumstances showing an intent to conceal or misstate taxable sales, presents a sufficient basis for inferring fraud. (See *ibid*.) Circumstantial evidence of fraud or intent to evade taxation includes the following: substantial discrepancies between recorded amounts and reported amounts that cannot be explained; sales tax or sales tax reimbursement is properly charged (evidencing knowledge of the requirements of the law) but not reported; inadequate records; failure to file tax returns; implausible or inconsistent explanations of behavior; concealment of assets; failure to cooperate with tax authorities; and lack of credibility in the taxpayer's testimony. (*Appeal of Landeros*, 2024-OTA-655P; *Appeal of ISIF Madfish, Inc.*, 2019-OTA-292P.)

Here, appellant knew the requirements of the Sales and Use Tax Law because it maintained an active seller's permit, kept accurate records of its taxable sales, and properly computed and collected sales tax reimbursement from its customers. However, despite this knowledge, appellant did not report taxable sales of $2,100,881 made by the Oakland restaurant during the liability period. Appellant's underreporting of taxable sales for the Oakland restaurant was repeated over successive quarters during the liability period: there was underreporting in 14 out of the liability period's 15 quarters (except for 4Q13); the quarterly underreporting ranged from $22,503 (for 1Q14) to $286,925 (for 3Q16); and the underreporting exceeded $100,000 for each of the liability period's last nine quarters.[13] Additionally, according to CDTFA's penalty memorandum, appellant's bookkeeper/manager/assistant notified appellant's lone member about the discrepancies between appellant's recorded and reported taxable sales, but appellant's member disregarded the information. Such behavior shows an intent to conceal or misstate taxable sales and constitutes circumstantial evidence of fraud or an intent to evade. Coupled with the repeated understatements in successive reporting periods, this presents a sufficient basis for inferring fraud.

On appeal, appellant makes five sets of contentions regarding the fraud penalty. OTA will address each group of contentions in turn.

[13] See footnote 9, page 5.

First, appellant argues that CDTFA ignored the fact that this was appellant's first audit and disputes the fraud penalty on the basis that it is generally not warranted in first audits. In support, appellant cites to Regulation section 1703(c)(3)(A) and *Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 321-324. Appellant also quotes from various sections of Chapter 5 (*Penalties*) of CDTFA's Audit Manual.

Here, appellant confuses the fraud penalty with the negligence penalty. CDTFA imposed upon appellant the 25 percent fraud penalty pursuant to R&TC section 6485 and Regulation section 1703(c)(3)(C), *not* a 10 percent negligence penalty pursuant to R&TC section 6484 and Regulation section 1703(c)(3)(A). The case of *Independent Iron Works, Inc. v. State Bd. of Equalization*, *supra*, relates to the negligence penalty, noting that CDTFA "seldom, if ever, imposes a *negligence* penalty for errors discovered on a first audit." (Italics added.) To be clear: the penalty at issue is the fraud penalty, and authorities regarding the negligence penalty are distinguishable or not relevant. Additionally, CDTFA's Audit Manual has not been adopted pursuant to a formal rulemaking process, so no state agency (including OTA) can enforce, attempt to enforce, or even utilize CDTFA's Audit Manual as a manual, guideline, or standard of general application. (*Appeal of Micelle Laboratories, Inc.*, 2020-OTA-290P, at p. 15, fn. 20, citing Gov. Code, § 11340.5.) Accordingly, OTA will not consider or discuss appellant's arguments against the fraud penalty to the extent that they rely upon CDTFA's Audit Manual for authority. For the reasons stated, OTA finds that appellant's first argument lacks both supporting authority and merit.

Second, appellant contends that the appeals conference holder for CDTFA's Appeals Bureau improperly barred appellant from disputing the fraud penalty and providing proof, allegedly stating that she had no authority to relieve taxes or penalties. Appellant further asserts that the Appeals Bureau's decision did not address its request for penalty abatement and interest relief.

Contrary to appellant's second contention, in an email to appellant dated October 15, 2021, the appeals conference holder clarified that she had not concluded that she lacked the jurisdiction to relieve penalties at the appeals conference but was still gathering evidence. Further, CDTFA's decision did in fact address the fraud penalty and whether it was merited in "Issue 3" of the decision.[14] Finally, appellant's appeal is now before OTA, which is an independent and impartial appeals body. In general, OTA has jurisdiction to hear and decide a taxpayer's timely appeal of an adverse CDTFA Appeals Bureau decision. (See Cal. Code

[14] CDTFA addressed the issue of interest relief under "Issue 4" of its decision.

Regs., tit. 18, § 30103(b)(1).) OTA finds appellant's second set of arguments is premised on incorrect facts and is unpersuasive.

Third, appellant contends that its lone LLC member, P. Bell, had not previously operated a business, and had no history with, or knowledge of, the Sales and Use Tax Law. Appellant alleges that P. Bell did not operate the POS systems, open the cash drawer, or request cash from the cash register; rather, a designated staff member deposited the cash at the bank two or three times a week. Appellant alleges that P. Bell relied upon a bookkeeper to file appellant's SUTRs, and any underreporting was by the bookkeeper. Appellant argues that it should not be penalized for mistakenly trusting the wrong bookkeeper. Appellant asserts that P. Bell has been a stellar business owner, was unaware of any understatement, and immediately took action to make payments. Appellant also asserts that CDTFA ignored P. Bell's 30 years of service as a firefighter to the State of California.

Here, P. Bell is the sole member of appellant, an LLC. He applied for a seller's permit as a sole proprietor with an effective start date of November 1, 2012. Based on the books and records CDTFA obtained upon audit (i.e., bank statements, Form 1099-K data, and POS system sales reports), P. Bell opened a business bank account and a credit card processing account for appellant and implemented a POS system to record its sales. P. Bell also hired an in-house bookkeeper/manager/assistant, who electronically signed and filed the SUTRs. Based on this, OTA finds that P. Bell actively participated in the daily operation of appellant's business. P. Bell had also been operating the business for approximately 3.5 years when CDTFA's notified him that it had selected his seller's permit account for an audit via letter dated April 20, 2016.

All of appellant's sales were subject to tax, and appellant collected sales tax reimbursement from its customers during the liability period as verified by CDTFA upon its review of the POS system sales reports during the audit. Appellant also claimed deductions for sales tax reimbursement included in reported sales on its SUTRs for 4Q15 and 1Q16. Accordingly, OTA finds that appellant was knowledgeable of its obligations under the Sales and Use Tax Laws. Despite this, all of the following amounts exceeded the amount of sales appellant reported on its SUTRs for corresponding time periods: gross receipts reported on the 2014 FITR; bank deposits from sales proceeds per bank statements for January 1, 2015, through March 31, 2016; credit card sales per Form 1099-K data for the periods April 1, 2013, through September 30, 2013, and April 1, 2014, through March 31, 2016; and recorded sales per POS system sales reports for 3Q13 and October 1, 2013, through December 31, 2016. Further, appellant's recorded sales tax per POS system sales reports for the liability period exceeded the amount of tax appellant reported on the corresponding SUTRs. This evidence

shows that P. Bell and the bookkeeper had sufficient information available to identify the discrepancies between appellant's records and what it reported on its SUTRs. Appellant, an LLC, can only act through its members or principals; thus, their knowledge and actions are imputed to appellant. (See *FMC Corp. v. Plaisted & Companies* (1998) 61 Cal.App.4th 1132, 1213.) Accordingly, OTA finds that appellant must have known that taxable sales reported on the SUTRs were significantly understated.

The understatement totaled $2,348,821 (excluding the amount of unreported taxable mandatory tips) during the liability period, and appellant has not provided a credible explanation for this understatement. The difference equates to an understatement of 304 percent (unreported taxable sales of $2,348,821 excluding taxable mandatory tips ÷ reported taxable sales of $771,783), meaning appellant only reported approximately one third of its taxable sales for the liability period. Further, except for 4Q13, appellant consistently and systematically underreported its taxable sales throughout the liability period. This pattern of underreporting is strong evidence of fraud. (See *Baumgardner v. Commissioner* (9th Cir. 1957) 251 F.2d 311, 322.) Finally, although P. Bell's past career as a firefighter is commendable, OTA does not see its relevance to his more recent role as a restauranteur. Accordingly, OTA finds appellant's third set of arguments unpersuasive.

Fourth, appellant states that it was struggling because of the COVID-19 pandemic and P. Bell's related health issues, and appellant was forced to close the Antioch restaurant. Appellant also offers a $25,000 settlement.

OTA empathizes with appellant's financial issues and P. Bell's health issues, but these are not bases for reducing or deleting the fraud penalty. Regarding appellant's settlement offer, OTA has no authority to either settle or compromise a tax liability; OTA's jurisdiction in this case is limited to determining the correct amount of an appellant's tax liability.[15]

Fifth and finally, appellant contends that the Coronavirus Aid, Relief, and Economic Security (CARES) Act provides for relief of penalties and interest. Appellant asserts that neither CDTFA nor OTA has the authority to deny relief through this program. However, appellant has not provided any support for its assertions, and OTA knows of no provision of the CARES Act—a federal economic assistance bill—that would mandate relief of penalties and interest associated with liabilities established under the State of California's Sales and Use Tax Law.

Based on the foregoing, OTA finds that appellant's actions cannot be attributed to an honest mistake or to negligence, and CDTFA has established that appellant intended to evade

[15] OTA notes that appellant had applied for a settlement with CDTFA, but the parties could not reach an agreement.

the payment of tax that it collected and knew was due, with clear and convincing evidence. Thus, OTA concludes that CDTFA properly imposed the 25 percent fraud penalty for 2Q13 and 4Q13.

Issue 3: Whether CDTFA properly imposed the 40 percent penalty; if so, whether relief of the penalty is warranted.

CDTFA applied a 40 percent penalty of $86,249.24 to the liability determination for the periods 3Q13 and January 1, 2014, through December 31, 2016.

For determinations made before January 1, 2025, any person who knowingly collects sales tax reimbursement and fails to timely remit that tax reimbursement to CDTFA is liable for a penalty of 40 percent of the amount not timely remitted. (Former R&TC, § 6597(a)(1).) The penalty does not apply if the person's liability for unremitted sales tax reimbursement averages $1,000 or less per month or does not exceed 5 percent of the total amount of the tax liability for which the sales tax reimbursement was collected for the period in which the tax was due, whichever is greater. (Former R&TC, § 6597(a)(2)(A).) If a person's failure to make a timely remittance of sales tax reimbursement is due to a reasonable cause or circumstances beyond the person's control and occurred notwithstanding the exercise of ordinary care and the absence of willful neglect, the person shall be relieved of the 40 percent penalty. (R&TC, § 6597(a)(2)(B).)

Here, based on a review of the available POS system sales reports, CDTFA found—and appellant does not dispute—that appellant collected sales tax reimbursement on all its sales. Using appellant's POS system sales reports, CDTFA compiled recorded sales tax totaling $288,952 for the liability period. Upon comparison to reported sales tax of $66,716 for that same period, CDTFA computed unremitted sales tax reimbursement of $222,236. CDTFA concluded that appellant knowingly collected and failed to remit sales tax and that the unremitted sales tax reimbursement exceeded an average of $1,000 per month and 5 percent of the total sales tax reimbursement for each quarterly period in the audit except for 2Q13 and 4Q13. Thus, CDTFA found that the 40 percent penalty was applicable to 3Q13, and the period January 1, 2014, through December 31, 2016.

OTA reviewed the evidentiary record as well as CDTFA's audit working papers and found two errors in CDTFA's computations with respect to the statutory thresholds of the 40 percent penalty. First, CDTFA's computations use reported sales tax of $66,716 for the liability period per appellant's SUTRs. But in the audit working papers (specifically audit schedule 414M), CDTFA noted that appellant erred in its sales tax reporting, which should have

totaled $71,054. According to CDTFA, appellant was billed for and paid the difference. Thus, CDTFA should have used $71,054 in computing the quarterly and monthly amounts of unremitted sales tax reimbursement. Second, CDTFA erred in calculating the quarterly percentage of unremitted sales tax reimbursement. CDTFA divided the average *monthly* amount of unremitted sales tax reimbursement by the total quarterly recorded amount of collected sales tax reimbursement. Instead, CDTFA should have divided the *quarterly* amount of unremitted sales tax reimbursement by that latter amount.

Correcting for these two errors, OTA found that unremitted sales tax reimbursement exceeded an average of $1,000 per month and 5 percent of the total sales tax reimbursement for each quarter in the liability period *except* for 1Q14 (in addition to 2Q13 and 4Q13). In 1Q14, the quarterly difference was $2,023 ($11,475 recorded collected sales tax reimbursement - $9,452 paid sales tax), which averages out to $674 in unremitted sales tax reimbursement per month ($2,023 ÷ 3 months). Thus, the unremitted sales tax reimbursement did *not* exceed an average of $1,000 per month, so the 40 percent penalty cannot apply to 1Q14.[16] However, because OTA concluded that CDTFA established fraud by clear and convincing evidence (see Issue 2 of this Opinion), CDTFA should apply the 25 percent fraud penalty to 1Q14 (in addition to 2Q13 and 4Q13).

As explained in Issue 2 of this Opinion, OTA finds that appellant's lone LLC member and bookkeeper were active in appellant's day-to-day operations and implemented a POS system to record sales and sales tax. Thus, appellant knew that it charged and collected sales tax reimbursement on all its sales. OTA also found that appellant knew the actual sales amounts and sales tax collected. Appellant does not dispute the tax liability, which is based on sales and sales tax recorded in appellant's POS system sales reports. Therefore, OTA finds that appellant knowingly collected sales tax reimbursement but failed to timely remit that tax reimbursement to CDTFA.

In its request for relief, appellant argues that it was not fraudulent. However, the 40 percent penalty is not a fraud penalty (*Appeal of Finnish Line Motorsports, Inc.*, 2019-OTA-138P), and thus does not require a showing of fraud or an intent to evade tax by clear and convincing evidence. It is sufficient that the case under consideration meets the requirements of former R&TC section 6597, which applies to determinations made prior to January 1, 2025; for the reasons stated above, OTA finds that this case does meet those requirements.

[16] Although the unremitted sales tax reimbursement of $2,023 for 1Q14 exceeds $573.75 (i.e., 5 percent of total sales tax collected of $11,475 for 1Q14), $1,000 per month is the relevant threshold because it is greater than $573.75. (See former R&TC, § 6597(a)(2)(A).)

On appeal, appellant has not described any facts and circumstances that would justify relief of the 40 percent penalty. Appellant has not explained why it failed to report substantial amounts of taxable sales or to remit collected sales tax reimbursement that were clearly recorded in its own records. Thus, appellant has not shown that its failure to remit collected sales tax reimbursement was due to reasonable cause or circumstances beyond its control and occurred notwithstanding its exercise of ordinary care in the absence of willful neglect. Accordingly, OTA finds that relief of the 40 percent penalty is not warranted.

In summary, OTA finds that CDTFA properly applied the 40 percent penalty to 3Q13 and the period April 1, 2014, through December 31, 2016, because appellant knowingly collected sales tax reimbursement but failed to timely remit them to CDTFA, and the quarterly amounts of unremitted sales tax reimbursement exceeded the applicable thresholds for these periods. However, for 1Q14, CDTFA should replace the 40 percent penalty with the 25 percent fraud penalty.

Issue 4: Whether additional relief of interest is warranted.

The amount of CDTFA's determination, exclusive of penalties, shall bear interest from the last day of the month following the quarterly period for which the amount should have been paid to the date of payment. (R&TC, § 6482.) Interest may be relieved in only limited circumstances. As relevant here, CDTFA, in its discretion, may relieve interest where the failure to pay the tax was due in whole or in part to an unreasonable error or delay by a CDTFA employee acting in his or her official capacity. (R&TC, § 6593.5(a)(1).) An error or delay shall be deemed to have occurred only if no significant aspect of the error or delay is attributable to an act of, or failure to act by, the taxpayer. (R&TC, § 6593.5(b).) When reviewing CDTFA's denial of a taxpayer's request for interest relief, OTA applies an abuse of discretion standard. (*Appeal of Micelle Laboratories, Inc.*, 2020-OTA-290P.) To show an abuse of discretion, a taxpayer must establish that, in refusing to relieve interest, CDTFA exercised its discretion arbitrarily, capriciously, or without sound basis in fact or law. (*Appeal of Eichler*, 2022-OTA-029P.)

Here, in October 2021, appellant filed with CDTFA a request for interest relief on the following six bases: (1) the audit was allegedly "shelved" from July 2016 through December 2016; (2) appellant provided its POS system sales reports in January 2017 but CDTFA did not issue the NOD until May 2018; (3) CDTFA's decision to include the Antioch restaurant caused a delay of nine months in 2017; (4) consideration should be given for the period during the COVID-19 pandemic; and (5) appellant had made a reasonable settlement

offer of approximately ten percent of the liability; and (6) paying interest would be a financial hardship for appellant.

CDTFA's Appeals Bureau reviewed the history of the audit and, in its decision, found sufficient activity (e.g., efforts to obtain appellant's records, analysis of such records, etc.) during the period April 20, 2016 (the date of the audit engagement letter) through August 2016 and again during the period December 2016 through May 1, 2018 (the date of the NOD). However, for the period September 1, 2016, through November 30, 2016, the Appeals Bureau found that CDTFA's analysis of the POS system sales reports took longer than typically expected during an audit, and CDTFA did not document any work on the audit during this period. Accordingly, the Appeals Bureau determined that there was unreasonable error or delay by a CDTFA employee during the period September 1, 2016, through November 30, 2016, and recommended relief of interest for that period.

Regarding appellant's claim that CDTFA's decision to include the Antioch restaurant in the audit caused a delay, the Appeals Bureau found the following: (1) the available evidence indicated that appellant operated the Antioch restaurant during 1Q16 so the audit had to include those sales; (2) there was no evidence indicating that including the Antioch restaurant in the audit resulted in a significant audit delay; and (3) appellant's failure to obtain a separate seller's permit for the Antioch restaurant, as well as appellant's failure to clearly explain its operations, contributed to any additional time CDTFA needed to accurately audit appellant. Regarding appellant's argument about the COVID-19 pandemic, the Appeals Bureau noted that it had stopped the accrual of interest on this liability during the period March 2020 through December 2020, and appellant did not provide grounds for additional relief due to the pandemic. Finally, regarding settlement and financial hardship, the Appeals Bureau referred appellant to CDTFA's Settlement Bureau and noted that financial hardship was not a basis upon which it could grant interest relief.

On appeal to OTA, appellant requests that OTA review the history of the audit but does not specify any period of alleged delay. Rather, appellant recounts audit-related events during the period February 2017 through March 2018, and includes documents from the period October 2019 through July 15, 2022 (i.e., the date of the Appeals Bureau's "options letter" informing appellant that some interest had been relieved and explaining appellant's options to request reconsideration from CDTFA or to appeal to OTA).

OTA has analyzed the record and finds CDTFA's decision not to relieve interest for periods other than September 1, 2016, through November 30, 2016, to be reasonable. Specifically, regarding the periods February 2017 through March 2018 and October 2019 through February 14, 2020 (i.e., the date interest stopped accruing because appellant fully paid off its tax liability), OTA finds CDTFA's analysis of these periods in the Appeals Bureau's decision to be accurate and reasonable and appropriately accounts for appellant's contributions to any delays. Accordingly, OTA finds that appellant has not established that CDTFA's refusal to relieve interest for these two periods was arbitrary, capricious, or without a sound basis in fact or law. Therefore, OTA concludes that additional relief of interest is not warranted.

HOLDINGS

1. The amount of unreported taxable sales and mandatory tips should not be reduced.
2. CDTFA established fraud with clear and convincing evidence.
3. CDTFA properly imposed the 40 percent penalty with respect to 3Q13 and the period April 1, 2014, through December 31, 2016. However, for 1Q14, CDTFA should replace the 40 percent penalty with the 25 percent fraud penalty.
4. Additional relief of interest is not warranted.

DISPOSITION

CDTFA's action is modified to replace the 40 percent penalty with the 25 percent fraud penalty for 1Q14. Otherwise, CDTFA's action in recommending relief of interest for the period September 1, 2016, through November 30, 2016, but otherwise denying appellant's claim for refund, is sustained.

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Andrew Wong
Administrative Law Judge

We concur:

Signed by:
Natasha Ralston
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Natasha Ralston
Administrative Law Judge

DocuSigned by:
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Teresa A. Stanley
Administrative Law Judge

Date Issued: 5/7/2025