

BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

IN THE MATTER OF THE APPEAL OF,)
)
SUNDOWN ENTERTAINMENT GROUP, INC.,) OTA NOS.231114672
THE COPA ROOM INCORPORATED,) 231014594
)
APPELLANTS.)
)
)

TRANSCRIPT OF ELECTRONIC PROCEEDINGS

State of California

Tuesday, December 16, 2025

Reported by:
ERNALYN M. ALONZO
HEARING REPORTER

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Transcript of Electronic Proceedings,
taken in the State of California, commencing
at 1:02 p.m. and concluding at 2:59 p.m. on
Tuesday, December 16, 2025, reported by
Ernalyn M. Alonzo, Hearing Reporter, in and
for the State of California.

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APPEARANCES:

Panel Lead: ALJ JOSH LAMBERT

Panel Members: ALJ ANDREW WONG
ALJ STEVEN KIM

For the Appellant: JESSE MCCLELLAN
ANITA KAY

For the Respondent: STATE OF CALIFORNIA
DEPARTMENT OF TAX AND
FEE ADMINISTRATION

SUNNY PALEY
CHAD BACCHUS
JEANINE CANDELARIA

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I N D E X

E X H I B I T S

(Appellant's Exhibits 1-5 were received into evidence at page 9.)

(Department's Exhibits A-L were received into evidence at page 9.)

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California; Tuesday, December 16, 2025

1:02 p.m.

JUDGE LAMBERT: We are now on the record in the Office of Tax Appeals oral hearing for the Appeals of Sundown Entertainment Group and The Copa Room Incorporated, Case Nos. 231114672 and 231014594. These appeals were consolidated for purposes of the oral hearing only, and a separate written opinion will be issued for each appeal. The date is December 16th, 2025, and the time is 1:02 p.m.

My name is Josh Lambert. I'm the lead panel member for this hearing, and my co-panelists today are Judge Steven Kim and Judge Andrew Wong.

So first, CDTFA, can you please introduce yourselves for the record by stating your names.

MS. PALEY: Sunny Paley, attorney with CDTFA.

MR. BACCHUS: Chad Bacchus, attorney with CDTFA.

MS. CANDELARIA: Jeanine Candelaria, hearing representative with CDTFA.

JUDGE LAMBERT: Thank you.

And, for Appellants, can you please introduce yourselves for the record by stating your names.

MR. MCCLELLAN: Yes. Jesse McClellan on behalf of Sundown and The Copa.

1 MS. KAY: Anita Kay on behalf of Sundown
2 Entertainment Group and The Copa Room.

3 JUDGE LAMBERT: Thank you.

4 Thank you all for attending.

5 The issues in this appeal are: For Sundown,
6 whether the Notice of Determination was timely issued
7 pursuant to Revenue & Taxation Code section 6487; whether
8 adjustments are warranted to the measure of unreported
9 sales tax reimbursement collected for the period
10 January 1st, 2011, through March 31st, 2017; whether the
11 40 percent penalty pursuant to R&TC section 6597 was
12 properly imposed, and if so, whether Appellants have
13 established that relief of the penalty is warranted;
14 whether further interest relief is warranted pursuant to
15 R&TC section 6593.5. And I'll note that CDTFA already
16 provided interest relief for December 2021, January 2022,
17 and March, April, and May of 2022.

18 For The Copa Room, the issues are whether the NOD
19 was timely issued pursuant to R&TC section 6487; whether
20 adjustments are warranted to the measure of unreported
21 taxable sales for the period of October 1st, 2013, through
22 March 31st, 2017; whether the 25 percent fraud penalty
23 pursuant to R&TC section 6485 was properly imposed;
24 whether the 40 percent penalty pursuant to R&TC section
25 6597 was properly imposed, and if so, whether Appellants

1 have established that relief of the penalty is warranted;
2 and whether further interest relief is warranted pursuant
3 to R&TC section 6593.5.

4 Okay. In terms of the exhibits, CDTFA submits
5 Exhibits A through L, and Appellant submitted Exhibits 1
6 through 5, with Exhibit 5 being the attachments to the
7 appeal letters for Sundown and The Copa Room. And also,
8 for Appellants there was an objection to CDTFA's exhibits
9 stating all the exhibits are multiple levels of hearsay
10 and lack foundation. Further, none of these exhibits
11 should be allowed based on order to return destroyed
12 property from Riverside Superior Court files
13 April 20, 2022.

14 And I'll just ask CDTFA if they have a response.

15 MS. PALEY: We do. Would you like me to proceed
16 now?

17 JUDGE LAMBERT: Yes, please.

18 MS. PALEY: Hearsay and unsworn evidence are
19 admissible in administrative hearings before OTA. The
20 rules of hearsay and foundation under the California
21 Evidence Code and California Code of Civil Procedure are
22 inapplicable per OTA Regulation 302154, which also states
23 that all relevant evidence is admissible, California Code
24 of Regulations Title 18 section 30214(f)(1). The OTA
25 regulations define evidence as any information contained

1 in the written record or oral hearing record that the
2 panel may consider when deciding an appeal. This may
3 include any relevant evidence that a panel determines to
4 be the sort of evidence responsible persons are accustomed
5 to relying on in the conduct of serious affairs. That's
6 California Code of Regulations Title 18 section 30102(n).

7 The Superior Court's order to return destroyed
8 property was sought by the Investigations Bureau following
9 conclusion of the criminal case to allow for the
10 destruction or return of property that had been seized
11 pursuant to the search warrant. The court order simply
12 states that the items may be returned to Mr. Di Lembo or
13 his representatives or destroyed in the event that any of
14 the parties do not want the items returned. The court
15 order further states that the items seized no longer have
16 any evidentiary value in the prosecution of this matter.
17 Nothing in the court order prohibits the Department from
18 using such items for audit, determination, or at
19 administrative proceedings. Furthermore, Revenue &
20 Taxation Code section 6481 allows the Department to
21 compute and determine the amount to be paid upon the basis
22 of any information within its possession.

23 Thank you.

24 JUDGE LAMBERT: Thank you, Ms. Paley. So, yeah,
25 I agree with what you're saying, and the language doesn't

1 seem mandatory and doesn't talk about this matter, and we
2 have broad discretion to accept relevant evidence. And
3 also, if the evidence presented and here, the order is not
4 really within our jurisdiction, it doesn't seem to prevent
5 the admission of it. So I'll just overrule the objection
6 and allow it in.

7 So the evidence is now in the record.

8 (Appellant's Exhibits 1-5 were received into
9 evidence by the Administrative Law Judge.)

10 (Department's Exhibits A-L were received into
11 evidence by the Administrative Law Judge.)

12 So at this time we can move on to the
13 presentations.

14 And, Mr. McClellan, you have two hours as
15 discussed. So this is your opportunity to explain
16 Appellants' position, and you can proceed when you are
17 ready.

18 MR. MCCLELLAN: Sorry about that. I was on mute.

19 Thank you, Judge Lambert. I think my co-counsel
20 in this, Anita Kay, is going to lead off; and then I'll
21 take it from there before we turn it over to the
22 Department.

23 MS. KAY: Thank you, Jesse.

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1 went to preliminary hearing in 2021. That investigator is
2 an arm of law enforcement. He worked with the District
3 Attorney's office. So from 2017 to 2021, this case was
4 ongoing. There was a five-day preliminary hearing in
5 which the CDTFA called numerous witnesses that they were
6 to testify. The judge said there is not enough evidence
7 to pass the Centella test. That's the burden at a
8 preliminary hearing, preponderance of the evidence. It is
9 the lowest burden there is. The absolute lowest burden,
10 and they could not meet that burden.

11 The evidence that was presented couldn't even
12 come in because there were problems with the foundation.
13 There were problems with the hearsay of where did this
14 evidence come from. And that's the same evidence that
15 they're trying to use here, which is potentially POS
16 reports that we have no idea where they came from. They
17 don't even exist anymore. So how is the CDTFA to talk
18 about these POS reports when they don't even have them.
19 They were ordered destroyed because they have no
20 evidentiary value. Period. End of sentence. No
21 evidentiary value whatsoever.

22 So it's -- I don't even know how we get here to
23 be honest, because there's -- there's nothing that the
24 CDTFA has that there should even be allowed to use. But
25 if you cannot meet the most basic burden, the smallest

1 burden, preponderance of an evidence, there is no way they
2 can meet the burden here. You could not meet it in a
3 civil court, the clear and convincing. There's no way you
4 can prove fraud, which is what they're trying to do.

5 I don't know how many people here have ever done
6 a preliminary hearing of any criminal background, but
7 to -- to get a holding order at a preliminary hearing is
8 the easiest thing to do. That it is so easy that
9 99.9 percent of all preliminary hearings are held to
10 answer. This one wasn't because they couldn't meet that
11 burden. So where they get this evidence from, I -- I
12 don't know because there was never an audit done. Once
13 that case was dismissed, somehow the CDTFA got together
14 with documents that they should not have had and decided
15 to do an audit and then say, well, here's money owed.
16 That's the whole problem.

17 So while Jesse can talk about the 40 percent, the
18 25 percent, the basic and bottom line is I don't even
19 understand how we can get here when you have a Superior
20 Court Judge saying there is not enough to get past a
21 preponderance of an evidence. Why are we here talking
22 about clear and convincing evidence when you can't get
23 there? They're the same witnesses. They're trying to use
24 the same documents. It's the exact same case they're
25 trying to use in criminal that they're trying to use here,

1 which goes to the whole issue of collateral estoppel and
2 res judicata.

3 There was a full hearing for five days with all
4 of these witnesses who were sworn under oath, and they
5 couldn't meet that burden. And yet, we're here now
6 saying, oh, we'll just let all this evidence in. That
7 evidence didn't come in. There's -- it's -- it's just --
8 it's mind-blowing to me that -- that we are sitting here
9 when -- when you can't meet a burden at a preliminary
10 hearing, and here we are again trying to litigate this. I
11 just -- I -- it's just -- it's mind-blowing. And, you
12 know, there was -- there was talk in the appeal about
13 privity between the CDTFA and the District Attorney's
14 office. And when the CDTFA in the criminal investigation
15 is using evidence to pursue a criminal case, they can't
16 then just share it with whoever they want, even in the
17 same office, to try to make another case. That's --
18 that's not how that works. That's the criminal
19 investigation. They're walled off. You can't just keep
20 using and regurgitating the same thing to try to get a
21 different result because you didn't like what happened in
22 the criminal case; because you couldn't make it in the
23 criminal case.

24 So I don't understand what documents they're
25 using that they have no right to, to try to do an audit.

1 That's what I don't understand. I don't know where all of
2 the -- the documentation comes from. Because if I were to
3 say I would like to look at this documentation, they don't
4 have it. All of it has been destroyed. Where are the POS
5 systems? They don't exist. They're gone. So how can you
6 even test the validity of what they're trying to claim
7 now? I mean, those are the questions I have. I don't
8 know how we get to where we are right here without even
9 discussing penalties and fraud penalties and 25 percent.
10 I don't know how we can even get to where we are.

11 JUDGE LAMBERT: Okay. Thank you, Ms. Kay.

12 So, Mr. McClellan, are you going to continue on
13 as well or -- in the opinion we can address -- further
14 address any objections to the evidence and take into
15 account what was stated at the hearing today.

16 MR. MCCLELLAN: Yeah. I just -- I wasn't clear
17 if Ms. Kay was -- was just addressing the objection
18 response and making comments for the record or --

19 Ms. Kay, are -- are you done with the opening
20 presentation on your side of things?

21 MS. KAY: Jesse, if you want to talk about the --
22 the percentage? I mean, I can go back to collateral
23 estoppel and res judicata at the end. I mean, it's --
24 it's the same -- it's the same issue that it's been fully
25 and fairly litigated, and we're here again. And that's

1 just now how the legal system works. And when you have
2 Superior Court judge who is saying this doesn't make it,
3 you're not going to get another bite at the apple. It's
4 not how it works.

5 MR. MCCLELLAN: Okay. With that, I'd -- what I'd
6 like to do is look and examine, you know, what was
7 actually assessed here. And -- and some of this, of
8 course, was established in the briefing that was made.
9 But in -- in summary, we have an asserted liability issued
10 under a determination for the periods of 1/1/2011 through
11 March 31, 2017, and that's for the Sundown. There's a
12 separate determination that was issued for The Copa for --
13 bear with me. I'm just looking for the specific periods.
14 I'm sorry. I'm not -- I'm not seeing them. The focus,
15 initially, is going to be on Sundown. I think that the
16 issues that we'll discuss today will relate equally to
17 both of them. If the panel has any specific questions as
18 to distinction between the two cases, I'll certainly do my
19 best to answer those.

20 But ultimately, this -- this case initiated with
21 an audit selection for the original periods of third
22 quarter '12 through first quarter '15. What Ms. Kay
23 touched on was that the -- the audit suddenly stopped the
24 process. There was no communication. There was no
25 discussion with the taxpayer about the concerns that

1 apparently existed with CDTFA. It was transferred to
2 investigations.

3 It went -- it went quiet for roughly two years,
4 and then a seizure occurred. And, ultimately, CDTFA
5 attempted -- well, it did pursue criminal charges in
6 conjunction with the District Attorney's office, which
7 failed after a five-day preliminary hearing; which, of
8 course, is a hearing that well exceeds the hearings that
9 are afforded before the OTA or before the hearings that
10 used to be held before the Board of Equalization. Both of
11 which have been held to be sufficient for purposes of res
12 judicata. And Ms. Kay can touch on the aspects of res
13 judicata and collateral estoppel further.

14 The focus that -- that I want to discuss -- and
15 it gets a little technical, so -- so bear with me. And,
16 of course, we can have some follow-up discussion on this.
17 But, ultimately, CDTFA didn't assess a fraud penalty in
18 this case. Now, what it did assess is the 40 percent
19 penalty that's established under Code section 6597. And
20 the -- the issue with that is that CDTFA recognizes, and
21 OTA has held in prior decisions that the 40 percent
22 penalty, which I'll refer to the penalty established under
23 Code section 6597 as the 40 percent penalty, and the
24 penalty that's established under 6485, which is a fraud
25 penalty as the 25 percent penalty or the fraud penalty.

1 The -- the problem with the 40 percent penalty is
2 that it does not extend the statute of limitations. And
3 we'll get into, here in a moment, the details of the
4 analysis for why that matters. But, ultimately, for
5 purposes of context for the panel today, it's -- it's our
6 viewpoint that not assessing the fraud penalty is contrary
7 to the plain language of Code section 6485, first and
8 foremost that states that it shall be added to the
9 determination. So it's not discretionary to CDTFA. And
10 then, ultimately, unless a fraud penalty was added to the
11 determination, as required by 6485, that the statute of
12 limitations for that determination is not suspended. And
13 that it's only through the addition of the fraud penalty
14 on that determination that suspends the statute of
15 limitations for that determination.

16 I guess, you know, maybe a simple analogy may be
17 something like needing to pay a toll in order to get
18 across a bridge. And in this case, the toll would be the
19 assessment of the penalty on the determination of legal
20 document that's issued to establish a liability in this
21 matter. It is the determination for which CDTFA issued a
22 decision. It is the determination for which a petition
23 for determination -- a redetermination was filed. It is
24 the determination that is under appeal and before OTA
25 today; and it doesn't have a fraud penalty assessed on it.

1 So one of the arguments that we've set forth in
2 our briefs is that fraud isn't relevant because it hasn't
3 been added. And what I'd like to do is -- is get to the
4 reason why we think it's not relevant and why the statute
5 of limitations cannot be suspended by issuing a 40 percent
6 penalty. Ultimately, what I'd like to do is -- is start
7 with the language -- the operative language of 6485 and
8 then go to the language of Regulation 1703 that addresses
9 penalties, both of which CDTFA is bound to. And from
10 there, I'd like to briefly address the history of 6597,
11 the 40 percent penalty. This practice by CDTFA is not
12 something that was historically done when the 40 percent
13 penalty was established. We'll discuss the legislative
14 record, and that there's nothing in the legislative
15 history that supports that CDTFA should use the 40 percent
16 penalty instead of any other penalty or vice versa.

17 And then I want to go to the Department's
18 support, including the decision that was issued by
19 Appeals, which the Department adopted per its brief that
20 was filed in this matter. And I'll explain in detail why
21 the basis for what they're doing is not supported by
22 well-established law. Ultimately, that's going to include
23 rules of construction, including rules that establish that
24 CDTFA or any other person can't just read a sentence or a
25 code section in isolation to the exclusion of another code

1 section under the same statutory structure, especially as
2 here where we have the relevant code sections within the
3 exact same chapter.

4 I mean, when looking at it on paper, they're just
5 a couple of paragraphs away. Yet, CDTFA's reading ignores
6 and renders 6485 in this case meaningless. And it can't
7 do that with -- within the confines of rules of statutory
8 construction. I'll provide several citations to
9 California law that requires that reading. Ultimately, at
10 the conclusion of this discussion, we're going to be
11 asking OTA and are asking OTA to cancel the determination
12 because it's not issued timely; because a fraud penalty
13 was not assessed as required under the law. And it's only
14 through the assessment, not even mere allegation of fraud,
15 that the statute of limitations suspends the statute of --
16 I'm sorry. It's only through the assessment of fraud that
17 the statute of limitations is suspended.

18 So getting back to the language of Code section
19 6485, quote, "25 percent penalty. If any part of the
20 deficiency for which a deficiency determination is made is
21 due to fraud or an intent to evade this part or authorized
22 rules and regulations, a penalty of 25 percent of the
23 amount of the determination shall be added thereto." The
24 language is very, very clear. "Shall be added thereto."
25 CDTFA in this case has alleged fraud. It has not added a

1 fraud penalty in violation of Code section 6485. It
2 doesn't in there. Under Regulation 1703 subsection
3 (c) (3) (C), provides a penalty of 25 percent of the amount
4 of the tax best supplied in any deficiency determination
5 shall be added thereto if any part of the deficiency for
6 which the determination is made is due to fraud or intent
7 to evade the sales and use tax law or authorized
8 regulations.

9 So Regulation 1703 really says the exact same
10 thing with slightly different wording that if fraud is
11 alleged, it shall be added to the determination. It's not
12 discretionary. The Department doesn't get to throw
13 another penalty in lieu of fraud. It doesn't get to
14 assess other penalties instead of fraud, enjoy the
15 extended statute of limitations that's provided under the
16 statutory scheme for fraud and assess a higher 40 percent
17 penalty for reasons that I hope the Department will
18 explain today, because it hasn't been explained.
19 There's -- there's, frankly, nothing in the Revenue &
20 Taxation Code or implementing sales and use tax
21 regulations that support the Department is authorized to
22 assess the 40 percent penalty instead of, which is what
23 admit expressly say they're doing in the decision, instead
24 of the 25 percent fraud penalty and suspend the statute of
25 limitations. That's the problem, Judge Lambert.

1 Now, we're not so much arguing that the
2 40 percent penalty isn't properly established. There's
3 some issues that -- that exist there as to whether or not
4 excess -- well, I should say whether or not tax
5 reimbursement was -- was included or added specifically to
6 sales in the bar of these establishments. But the-- the
7 real issue, at least as it pertains to my portion of -- of
8 the case, is just that. That -- that there's an
9 allegation of fraud. There's a clear statutory
10 requirement to add a 25 percent fraud penalty, and it's
11 not been added. So I don't know -- I'm not entirely sure
12 why the Department has -- has decided to do that. I mean,
13 one -- one reason is perhaps that it -- it recognizes that
14 CDTFA sought a criminal prosecution for fraud -- for
15 criminal tax fraud under the Revenue & Taxation Code; and
16 that after a five-day hearing, that the Court concluded
17 that the minimal burden that was -- as Ms. Kay pointed
18 out, preponderance of the evidence or potentially even
19 probable cause. I think it may be lower than
20 preponderance, but that couldn't be satisfied.

21 Or maybe the Department just really wanted to --
22 to maximize the revenue or punishment for this taxpayer by
23 assessing a higher penalty and still seeking to expand the
24 statute of limitations. But, certainly, it's not
25 something that it used to do. We're not entirely sure why

1 it started doing it. It seem to be contrary to the
2 Taxpayer Bill of Rights for it to simply seek out an
3 established an accurate amount of liability and -- and to
4 adhere to the authority granted to it within the law,
5 especially, where it's clearly and plainly stated, and to
6 assess a liability for whatever it may be to the best of
7 its ability.

8 Now, look into the history of Code section 6597,
9 the 40 percent penalty was added into law in 2006. It
10 went into effect January 1 of 2007. I've looked at
11 legislative history. The legislative history has
12 addressed in some detail in OTA's precedential decision in
13 ISIS Madfish. And there's certainly nothing in the
14 legislative history that supports the 40 percent penalty
15 was intended to be used instead of the 25 percent penalty.
16 I think this is addressed by the fact that the Department
17 didn't use to seek to assess the 40 percent penalty
18 instead of the 25 percent penalty. Supporting that, it
19 understood what the intent of the legislature was. And,
20 in fact, the legislative record pretty clearly states that
21 the 40 percent penalty is not a fraud penalty. So it's
22 not as if there should really be any confusion there.

23 Again, the OTA's case in ISIS Madfish makes it
24 clear that the legislature stated that it's not a -- a
25 fraud penalty. And, in fact, we would submit that the

1 40 percent penalty is specifically designed. And if you
2 look back at this history of it -- and I know that, you
3 know, some of the panel and -- and CDTFA's representatives
4 were around when all of this was created -- that it was --
5 it was really designed to apply where fraud didn't apply,
6 such that if CDTFA could not expand the statute of
7 limitations in a scenario where there were taxes collected
8 knowingly that weren't remitted, yet it couldn't establish
9 the elements of fraud, that the 40 percent penalty would
10 be applied.

11 Now, I'll -- I'll add for some context. Once
12 upon a time, CDTFA, formally the Board of Equalization,
13 suggested that the 40 percent penalty was a fraud penalty.
14 That came and went before the Board of Equalization, was
15 transferred from administering the sales and use tax law.
16 But needless to say, the legislative record doesn't
17 support what the Department is doing here. And, in fact,
18 we think the legislative record is contrary to what the
19 Department is doing here because the Department is
20 effectively alleging fraud and assessing a 40 percent
21 penalty, which effectively treats it as a fraud penalty.
22 It's the only penalty that's being assessed under the
23 Department's allegation of fraud. And the only way it
24 gets assessed is through the Department's allegation of
25 fraud, because otherwise the statute of limitations has

1 expired, which I'm not sure if I -- if I made that
2 sufficiently clear in laying this out. But, of course,
3 given the timing of the periods at issue and the date the
4 determination was issued, if the statute of limitations is
5 not suspended, and we submit that it very clearly is not
6 and it's untimely, it must be canceled.

7 Now, turning to the Department's claim support
8 for the penalty. First of all, I've already addressed
9 that the Department's actions here are in violation of the
10 plain language of the law. But, nonetheless, what the
11 Department says is that well, there's nothing in the law
12 that precludes them from doing it. It's expressly stated
13 in the decision that hey, look, there's nothing that says
14 we can't do it, so we can do it. Well, that argument
15 fails for at least two reasons. First, this was the same
16 argument that the Department made in *Diageo-Guinness USA,*
17 *Inc. v State Board of Equalization* 2012, 205 Cal.App.4th
18 907, regarding its right to assess excise tax on malt
19 beverages. In that case, CDTFA also argued that there was
20 nothing that says they can't do it. So they went ahead,
21 and they did it.

22 The argument was shot down by the Court of the
23 Appeals on the basis that CDTFA is an agency of limited
24 authority, and that even though CDTFA was not expressly
25 precluded from including malt beverages in a higher excise

1 tax bracket, such negative authority is not what controls.
2 The Diageo court reconfirm the principle that CDTFA is
3 permitted only do that which it is expressly authorized,
4 not all but which it is expressly precluded from doing.
5 Sort of an obvious statement. I think, generally, we
6 would agree that an auditor can't pull someone over for
7 speeding and issue them a ticket. Certain that the
8 Revenue & Taxation Code doesn't say anything about an
9 auditor not doing that, but we apparently, we understand
10 that it can't. But this same principle also applies when
11 the calls might be a little bit closer. Perhaps where as
12 here, the Department seeks to get creative for reasons yet
13 to be described and assesses a higher penalty, or fails to
14 assess a penalty that it's mandated, even though it
15 alleges fraud. The same principles apply.

16 And second, even though the Department argues
17 that there's nothing in the law that precludes them from
18 doing that, we respectfully disagree. We think that the
19 law absolutely expressly precludes them from doing that,
20 based on what it says they must do. Again, Code section
21 6485 and Regulation 1703 expressly state that, if fraud is
22 alleged, it shall be added to the deficiency
23 determination, and there can be no dispute that it is not
24 added in this case. And as the panel certainly is
25 familiar with Newco Leasing v State Board of Equalization

1 1983, 143 Cal.App.3d 120, has been consistently recognized
2 by CDTFA and OTA as standing for the proposition that
3 CDTFA must follow its own regulations and, of course, must
4 follow the Revenue & Taxation Code that forms the basis
5 for those regulations.

6 The Department also argues that Code
7 section 6487, which deals with the limitation periods for
8 issuing deficiency determinations, doesn't require the
9 addition of a fraud penalty. I'll explain why that
10 doesn't hold water either under well-established
11 principles of law. 6487 is titled "Limitations Deficiency
12 Determinations." And it does not expressly state that a
13 fraud penalty must be added to a determination to suspend
14 the statute of limitations, but such a reading -- well,
15 let me back up for a moment. And that's the basis of what
16 the Department says. Hey, look, we don't have to add a
17 fraud penalty in order to suspend the statute of
18 limitations. We just have to find fraud, and that's all
19 we have to do. Don't look at 6485. We understand that
20 it's under the same Revenue & Taxation Code chapter. I
21 mean, it's -- it's 64 -- 6487 and 6485. Of course,
22 they're very close in number. They're just a couple of
23 paragraphs away, not that that makes difference.

24 I mean, ultimately, even if a Code section, for
25 example, the definition of sale, which resides in Code

1 section 6006, conflicted with a reading -- and a
2 questionable reading at that the Department had, it would
3 still control. Ultimately, we think it's a little more
4 obvious when it's under the same chapter.

5 Excuse me. I'm just gonna have a drink of water.

6 So what I'd like to do is just run through some
7 well-established rule of statutory construction.

8 Excuse me.

9 And what these well-established rules of
10 construction require -- and I want to emphasize require --
11 is that the law is to be read in context of the entire
12 statutory scheme in which it is contained. Neither CDTFA
13 nor OTA, respectfully, can just focus in on a -- on a
14 particular Code section and -- and read it if the results
15 of that is going to make a different Code section or a
16 portion of a different Code section invalid or
17 meaningless. In *Union Oil Co. v State Board of*
18 *Equalization*, 1990 224 Cal.App.3d 665 at page 670, the
19 court states, "The meaning of a statute may not be
20 determined from a single word or sentence. The words must
21 be construed in context. The provisions relating to the
22 same subject matter must be harmonized to the extent
23 possible."

24 Here we're dealing with 6487 and 6485. Both of
25 them reference fraud. And in -- in CDTFA's

1 interpretation, it says 6487 absence of an expressed
2 requirement to assess a fraud penalty means we don't have
3 to assess it. We just have to allege it, and we can
4 suspend the statute of limitation. That renders Code
5 section 6485 meaningless because 6485 expressly states
6 that if fraud is established, CDTFA shall add a penalty to
7 the determination. Which, by the way, the determination
8 is what is the subject of topic of 6487. It all has to be
9 read together to give meaning to all its parts.

10 Now, of course, CDTFA I think knows this. At
11 least it knew it for I don't know, roughly 100 years up to
12 the point of roughly 2018 when it started to try this new
13 thing where it's issuing a 40 percent penalty, even though
14 it's alleging fraud and, you know, for that matter,
15 splitting up the periods and -- and adding different
16 penalties here and there. Respectfully, we think that
17 ISIS Madfish is not on solid grounds. But even ISIS
18 Madfish doesn't support what CDTFA is doing here. Because
19 in that case, there was fraud penalties that were
20 assessed. And the issue was, well, wait a second, fraud
21 penalty is supposed to be assessed. Can we also assess a
22 40 percent penalty? And does the statute of limitations
23 expire for the portion to which the 40 percent penalty
24 applied? OTA found yes, that the statute of limitations
25 is suspended so long as fraud is assessed for that period.

1 Well, this case is inconsistent with ISIS Madfish because
2 there is no fraud penalty assessed whatsoever.

3 Turning to some -- some other cases that I'd like
4 to -- to bring to the panel's attention. Department of
5 Alcoholic Beverage Control versus Alcoholic Beverage
6 Control Appeals Board 2006 40 Cal.4th 1 at page 11. The
7 California Supreme Court stated, "We do not construe
8 statutory language in isolation, but rather as a threat in
9 the fabric of the entire statutory scheme of which it is a
10 part. This goes to exactly what I'm saying. You can't
11 just isolate Code section 65 -- I'm sorry -- 6487 without
12 looking to 6485 and reading those two Code sections
13 together.

14 Finally in Select Base Materials, Inc. v Board of
15 Equalization. This dates back to 1959, 51 Cal.2nd 640 at
16 page 645, every statute should be construed with reference
17 to the whole system of law of which it is a part so that
18 all may be harmonized and have effect. If possible,
19 significance should be given to every word, phrase,
20 sentence in part of an act in pursuance of the legislative
21 purpose. The suggestion that Code section 6487 may be
22 read in isolation is clearly contrary to these
23 well-established rules of construction. Ultimately, CDTFA
24 can't ignore Code section 6485. It doesn't have authority
25 to do that.

1 If -- if fraud is alleged, 6485 requires that it
2 be assessed. The only way that CDTFA gets to the point
3 where it is -- is reasoning that it can't or that it
4 doesn't have to assess it, is by ignoring that Code
5 section, and that's not something that's permissible under
6 the law. Because what happens if -- if that's done? Is
7 it literally contradicts the plain language that says it
8 shall be added. It absolutely positively contradicts that
9 language. And -- and with respect to the meaning of 6485,
10 another rule of construction again, that is
11 well-established and -- and stated in *People v Salas*, 2017
12 9 Cal.App. 5th 736 at page 743, interpretations which
13 rendered any part of a statute superfluous are to be
14 avoided. And, ultimately, against CDTFA's reading here,
15 leaves 6485 without meaning whatsoever, and it can't do
16 that. Plus, we're requesting that OTA order the
17 determination to be canceled as untimely because the
18 determination does not have a fraud penalty assessed. And
19 it's only through the assessment of a fraud penalty in
20 accordance with the plain reading of the law that allows
21 the statute of limitations to be suspended.

22 Further, OTA's decision en re Senehi -- and I
23 apologize if I'm not pronouncing that correctly, but I'll
24 spell it here for the record, S-e-n, as in Nancy, e-h-i.
25 The cite is 2023 OTA-446P addresses the application of a

1 40 percent penalty while suspending the statute of
2 limitations under 6487 for fraud. Respectfully, for the
3 reasons we just laid out, and for reasons that are not
4 explored in that opinion, for reasons that are not
5 dissected in that opinion, ultimately, that opinion
6 reaches the conclusion that CDTFA seeks to advance. We
7 think it's very clearly not in accordance with the law,
8 and we respectfully request that OTA recognize that
9 decision as being invalid for the reasons that we just
10 discussed.

11 Now -- now, OTA concludes as -- as -- well, if
12 OTA concludes that CDTFA does have the right to do what it
13 seeks to do, notwithstanding what I just addressed, we
14 again respectfully urge OTA to address the authority and
15 the rules of construction, and the law that we cited for
16 the record and its opinion. And to -- to explain why
17 CDTFA would be allowed to ignore Code section 6485,
18 because it's only through ignoring 6485 and not following
19 the very clear and expressed language that it provides,
20 that it reaches a result which suggests that it has
21 authority to suspend the statute of limitations, even
22 though a fraud penalty is not assessed.

23 But that concludes my presentation on that
24 particular issue. We've going for about 50 minutes.

25 Judge Lambert, I -- I do have some more to add,

1 but I figured I'd give you a moment to see if -- if the
2 recorder needs a break, or if we need take a quick break.

3 JUDGE LAMBERT: Hi. This is Judge Lambert. I
4 don't think we need a break right now. So you can
5 continue if you want.

6 MR. MCCLELLAN: Thank you.

7 The other argument that we set forth in our brief
8 that really I think reenforces and goes to everything
9 that -- that was just discussed, is -- is whether or not
10 fraud is even relevant. And if it's not assessed on the
11 determination, which is the subject of the petition and
12 the subject of the appeal, we fail to see how it can be
13 relevant. I think it would be tantamount to CDTFA
14 suggesting possibility that there's additional liability
15 in an audit for one reason or another that's never
16 assessed. And -- and if it's never assessed, then it's
17 not relevant. If it doesn't reach the determination,
18 then -- then how is it relevant? Now, ultimately, this
19 ties directly into whether or not CDTFA may suspend the
20 statute of limitations for fraud, even though it's not
21 assessed, and even though the law very clearly requires it
22 to be assessed if it's alleged. We think the
23 determination ultimately is fatally flawed. We think it
24 must be canceled because it wasn't issued timely. And we
25 do believe that fraud isn't relevant because it has not

1 been assessed on the determination.

2 For the record, because the decision inexplicably
3 states that there's not a dispute, that fraud can be
4 established by clear and convincing evidence, that is
5 absolutely subject to dispute. That is something that was
6 disputed at the appeals conference. There's actually a
7 record of that proceeding in this case. But just to make
8 clear that -- that is subject to dispute, that CDTFA has
9 not established by clear and convincing evidence that --
10 that fraud should be apply. Now, the tricky thing about
11 this is, of course, we're arguing that it's a moot point;
12 that it frankly doesn't matter because it hasn't been
13 assessed. But, nonetheless, we -- we do find it necessary
14 to make that clarification. The -- the final point that I
15 will address -- and then I'll turn it back over to Ms. Kay
16 to see if she has anything to add -- is the relief of
17 interest. Now, ultimately, you know, we maintain on
18 behalf of our client that the -- that the determination
19 should be canceled. In the event that it's not canceled,
20 we believe that the interest spanning approximately six to
21 seven years during the time frame in which CDTFA ceased
22 all communications with the taxpayer, for a period of
23 time, and then commenced legal proceedings that couldn't
24 even get past the preliminary hearing stage is, in fact --
25 well, let's just break it down.

1 It's a delay. There's no question that there's a
2 delay there. Okay. That proceeding created a delay in
3 the audit process. There can be no question. Okay. The
4 statute then -- excuse me. I just have to take a drink of
5 water.

6 The statute then looks to determine who caused
7 the delay. Was it CDTFA's actions that caused the delay?
8 There's no question that CDTFA's actions caused the delay.
9 They instituted the investigation. They -- they pursued
10 criminal charges that, frankly, again it couldn't even get
11 past the preliminary hearing stage. It was a big waste of
12 taxpayer money and time. And, ultimately, this taxpayer
13 shouldn't be punished for that. I mean, the principle
14 endured that process as it was, which was extremely
15 stressful and difficult; and it was a failed effort.
16 So -- so, ultimately, we don't see how it could be
17 suggested anything but a -- a delay caused by CDTFA. It
18 was found to be unreasonable. And I will add that, as it
19 pertains to the unreasonable prong, if -- if it at least
20 got through the preliminary hearing stage, where there was
21 really the lowest level in existence of a standard to
22 overcome, that would be one thing.

23 If -- if a -- you know, if a court found that
24 CDTFA was justified in pursuing the charges, and that it
25 warranted that the defendant stand trial for those

1 charges, that's one thing. In this case, that's not what
2 was done. So to suggest that it was reasonable for them
3 to do it, despite the fact they couldn't get through the
4 preliminary hearing stage, even if they were to get
5 through the preliminary hearing and perhaps fail on a
6 conviction, again, a different story. But -- but that's
7 not what we're talking about here. So we have -- we have
8 a delay. We have a clear causation from CDTFA's
9 investigation and criminal pursuit, and we have a -- a
10 ruling on the record that says that it's unreasonable
11 because it couldn't satisfy a very low burden; a burden
12 which is significantly lower than the clear and convincing
13 evidence standard that we're here with today.

14 With that, I will conclude my comments. And
15 before we turn it over to the Department, if I may just
16 ask Ms. Kay if she has anything else to add.

17 MS. KAY: The -- the only quick side note with
18 regard to the issue of the hearsay -- and I understand the
19 ruling is that it's all coming in, and that hearsay comes
20 in at the administrative law hearing level -- that it
21 can't -- the judgment or the final outcome can't be based
22 solely on hearsay, and that is what the CDTFA is trying to
23 do. They're trying to base everything on hearsay, and
24 that's not what the administrative hearsay allows for.
25 It's to explain or to clarify certain things. But the

1 ruling itself cannot be based solely on hearsay, and that
2 is all that's here. And I will leave it at that.

3 JUDGE LAMBERT: Okay. Thank you, Ms. Kay and
4 Mr. McClellan.

5 I'll turn now to the panel to ask if they have
6 any questions.

7 Judge Wong, do you have any questions?

8 JUDGE WONG: Yeah. Excuse me. I just had a
9 couple of questions for Mr. McClellan just to kind of
10 explore his argument a little bit.

11 First, just to clarify, so your argument with
12 respect to Revenue & Taxation Code 6485, which goes to the
13 fraud penalty. So you're saying that if there's fraud in
14 a case, since CDTFA must assess the fraud penalty. And if
15 they don't assess the fraud penalty, that must mean that
16 there is no fraud?

17 MR. MCCLELLAN: Well, here's -- here's -- I mean,
18 I appreciate the question, Judge Wong. I think the way I
19 would respond to that is that, for purposes of the
20 determination, there's no fraud. And -- and that
21 ultimately Code section 6485, I think we would all agree,
22 couldn't be clearer where it says "shall be added there
23 too," right. And that 6485, just like any other code
24 section under the law that's implicated in a case,
25 absolutely has to be followed. And that what I'm saying

1 is that 6485 and 6487, under which CDTFA seeks to assert
2 authority for suspending the statute of limitations must
3 be read together.

4 So, for purposes of 6487, there is no fraud.
5 Now -- now, there could in theory, I guess, be fraud. But
6 if it's not assessed, it doesn't matter. And it doesn't
7 suspend the statute of limitations action absent an actual
8 penalty being assessed on the deficiency determination as
9 stated under 6485 and when read in conjunction with 6487.

10 JUDGE WONG: Okay. Thank you, Mr. McClellan.
11 And then my second question -- I think it's the last
12 question for now. I just want to raise a hypothetical
13 because I don't want to speak specifically about your
14 client in this hypothetical. But so assuming there's a
15 case that there is fraud, then CDTFA must -- by your
16 argument, they must assess a fraud penalty. But if
17 there's also -- if the elements of 6597 are met, could
18 they also add the 40 percent penalty, stack it on the same
19 liability period? It's kind of maximalist argument.
20 Like, if there's fraud -- 'cause I -- if I -- as I
21 understand your argument, if there's fraud, there must be
22 a fraud penalty. But then if there's also the 40 percent
23 penalty is -- is satisfied, could that be stacked on the
24 same quarter, like, the same liability period? Could
25 they -- if there's fraud, it opens up the statute of

1 imitations. There's no limitation period, and then so
2 CDTFA could just assess 25 percent, 40 percent, stacked
3 all the way for eight years or however long. Is --

4 MR. MCCLELLAN: Well, I don't know the answer to
5 that question. Well, let me -- let's strike that
6 response.

7 Allow me to clarify something here. Are you
8 asking hypothetically speaking? Let's just say that we're
9 detailing with fourth quarter '24, and there's a liability
10 of \$100,000. Are you -- are you asking whether CDTFA, in
11 my opinion under the law, would be authorized to assess a
12 25 percent penalty, and; in addition to, that, assess a
13 40 percent penalty which, under a \$100,000, tax liability
14 would be \$65,000? Is that the question?

15 JUDGE WONG: Yeah. Because as far as I
16 understand your argument, if there is fraud, then CDTFA
17 must assess. So I'm just trying to figure out, like, kind
18 of the policy implications of that. I guess it goes to
19 doesn't CDTFA have discretion? Like, shouldn't we --
20 should CDTFA have the discretion to choose whether to do
21 the 40 percent penalty or 25 percent penalty? Or must
22 they, if there's 40 percent -- if the elements of the 40
23 percent penalty are satisfied, and the elements of fraud
24 are satisfied, must they, like, kind of hammer a taxpayer
25 in that situation?

1 MR. MCCLELLAN: Well, certainly, I -- I wouldn't
2 suggest that they would be compelled to assess both
3 penalties. And, of course, the Audit Manual specifically
4 says that both penalties won't be applied. There's a --
5 there's authority -- it's been a little while since I've
6 looked at -- that makes it clear that, you know, a
7 negligence penalty and I think a finality -- and I may be
8 getting that wrong. But there's certain penalties that
9 can't be duplicated. I would -- I would certainly suggest
10 that now, under no circumstance, can the 40 percent
11 penalty and the 25 percent penalty be assessed to the
12 same. This essentially goes to what I would look at from
13 an expressed authorization standpoint that if the idea was
14 that the legislature wanted that to be part of the
15 statute. Very easily could have said it, and the
16 legislature, obviously, based on its record, addressed the
17 fraud factor. It discussed fraud.

18 And if the idea of the legislature was to say,
19 hey, look, we want to really punish fraudulent taxpayers.
20 We want to increase the penalties that they will pay by
21 taking those penalties in qualifying situations from
22 25 percent up to 40 percent. It would have said as much.
23 As far as your other question as to, you know, discretion,
24 yes, I -- I mean, I think -- well, let me just -- let me
25 just answer this the best way I can, is that I do see 6485

1 as being very clear, okay. And that if there is a finding
2 of fraud, that discretion goes away. But there is not a
3 discretion to assess a 40 percent penalty.

4 Now, whether or not the 40 percent penalty under
5 6597 also lacks discretion is, I think, debatable. And
6 that's, I think, part of the reason why historically
7 there's been some confusion as whether or not it's a fraud
8 penalty because of the knowledge aspect; whether or not
9 it's simply as triggered and has to be assessed if the
10 certain thresholds are met as it pertains to the amount of
11 tax that's collected per period and the percentage of that
12 tax that it represents per period. That -- that would be,
13 I think, the best answer that I can provide is that 6485
14 isn't discretionary because the language is so clear.
15 And -- and then 6597, I -- I honestly don't have an answer
16 as to whether or not that would be discretionary. But I
17 would say to the extent that there is some discretion and
18 there's question, if 40 percent is going to be assessed,
19 then it's not a situation where the statute of limitations
20 should also be suspended. And -- and ultimately, if the
21 legislature intended that to be the case, they would have
22 simply increased the fraud penalty to 40 percent.

23 JUDGE WONG: All right. Thank you,
24 Mr. McClellan. That's all the questions I have now. I
25 might come back to it on rebuttal and closing.

1 MR. MCCLELLAN: Okay.

2 JUDGE WONG: Thank you.

3 JUDGE LAMBERT: Okay. Thank you.

4 And, Judge Kim, do you have any questions?

5 JUDGE KIM: Yeah. I had a few questions here.

6 So just to clarify, were either of the Appellants
7 Copa or Sundown, were they defendants in the criminal
8 case?

9 MR. MCCLELLAN: Anita, do you want to --

10 MS. KAY: It was Tony Di Lembo who was the
11 defendant in the case. But as he is one of the owners, he
12 is in privity with The Copa Room and Sundown. So it is
13 the same entities. It's very rare in a criminal case that
14 they would charge the corporation, Judge Kim.

15 JUDGE KIM: Okay.

16 MS. KAY: I mean, basically, because you can't
17 send a corporation to prison. That's so it's -- it's the
18 officers that are charged in the criminal.

19 JUDGE KIM: Okay. And regarding the hearsay
20 argument, I just want to confirm. The -- the records that
21 were used by CDTFA here, were they -- weren't they the --
22 were they the business records that were seized during the
23 execution of the search warrant?

24 MS. KAY: Well, there were a lot of things that
25 were seized during the search warrant. So what exactly

1 was used by CDTFA? I don't know because I -- there were
2 documents that were taken from both Sundown and from Copa
3 that are potential business records, but because we can't
4 authenticate them, we cannot say that they truly are the
5 accurate business records because a lot of it is piecemeal
6 and documents found in various locations. And because the
7 POS system no longer exist, there's no way to authenticate
8 those records to say that those are true and accurate
9 business records.

10 So it's sort of like the computer, junk in, junk
11 out, right. You're only getting certain documents or
12 certain pages without the full picture. And then an audit
13 was created well after the criminal case concluded with
14 unclear what those documents were. Obviously, you know
15 our position is that they weren't entitled to keep those
16 documents. But it's also unclear as to what those
17 documents were because there's not a true and accurate
18 picture to even say that they're true and accurate
19 business records.

20 JUDGE KIM: Okay. Thank you. That's the
21 questions I had for now.

22 Thanks, Judge Lambert.

23 JUDGE LAMBERT: Thank you.

24 I don't have any questions at this time. Before
25 we go CDTFA's presentation, we could take a 10-minute

1 break. And so please turn off your cameras and mute your
2 microphones since the stream will continue, and we'll come
3 back around 2:18 p.m.

4 And go off the record. Thanks.

5 (There is a pause in the proceedings.)

6 JUDGE LAMBERT: So we're back on the record.

7 Now, we can move on to CDTFA's presentation for
8 one hour.

9 And, CDTFA, Ms. Paley, you could proceed when
10 you're ready.

11 MS. PALEY: Thank you.

12

13 PRESENTATION

14 MS. PALEY: Copa Room Incorporated, or Copa,
15 operated a night club with a bar, The Copa Room, and
16 Sundown Entertainment Group Incorporated, or Sundown,
17 operated an upscale restaurant and lounge, Tropicale, both
18 in Palm Springs, California. Mr. Di Lembo was the chief
19 executive officer of both Copa and Sundown. The
20 Department's Investigations Bureau received a referral
21 from the field office, Riverside, after examination of the
22 business records led the auditor to believe that taxable
23 sales were substantially understated.

24 A search warrant executed in July 2017,
25 Exhibits C-2 and I-2, enabled the review of point of sale

1 records, the Aloha System, federal income tax returns, and
2 bank records revealing substantial underreporting for both
3 Copa and Sundown. Specifically, the records show that
4 Copa made \$3.4 million in taxable sales from October 2013
5 to March 31st, 2017, and only reported \$1.8 million to
6 CDTFA.

7 Sundown made \$28.9 million in taxable sales from
8 January 2011 to March 31st, 2017, and only reported
9 \$13.4 million of it. This is shown in Exhibits C and I,
10 the evasion penalty memorandums; and Exhibits F and L, the
11 audit work papers. The investigation led to the criminal
12 prosecution of Mr. Di Lembo by the Riverside County
13 District Attorney in 2020 for felony tax evasion in
14 violation of Revenue & Taxation Code sections 7153.5 and
15 7152, and an aggravated white collar crime enhancement of
16 Penal Code section 186.1182 for multiple counts and
17 conduct exceeding \$500,000. The case did not proceed,
18 however, as there was a no-holding order at the
19 preliminary hearing in November of 2021.

20 Appellant has argued that collateral estoppel and
21 res judicata applied to this administrative proceeding,
22 claiming that the same issues or fraud were litigated in
23 the Riverside criminal, court, and that case was dismissed
24 at preliminary hearing. The issue sought to be precluded
25 whether or not there is proof for application of a fraud

1 penalty pursuant to Revenue & Taxation Code section 6485
2 was not litigated in the former proceeding; that a judge
3 found insufficient evidence presented at the preliminary
4 hearing by the D.A. to find that Mr. Di Lembo personally
5 filed the fraudulent sales tax returns.

6 The issue here of whether fraud was committed by
7 Appellants was not adjudicated, let alone, the
8 applicability of penalties for administrative billing.
9 The issues are not the same, nor were they litigated or
10 decided as is necessary for the doctrines of res judicata
11 or collateral estoppel to apply. As discussed in detail
12 in the decisions, Exhibits A and G's Exhibit 1, multiple
13 elements necessary for application of collateral estoppel
14 have not been met, including but not limited to privity.
15 Likewise, Appellant contends that the Notice of
16 Determinations are, therefore, barred by the statute of
17 limitations, and that the evidence used to make the
18 determination and for this hearing are inadmissible
19 because of the order to return or destroy a property,
20 Exhibits A and G-3.

21 First off, that order was sought by the
22 Department's investigator so that items seized and
23 obtained pursuant to the search warrant could be returned
24 or destroyed, and to not require further storage by the
25 Department upon conclusion of the prosecution of the

1 criminal case.

2 Second, the order is permissive in its
3 authorization. It indicates at line 18, "may be
4 returned," or at line 4, "can be destroyed." The use of
5 lawfully seized records to make billing determinations is
6 proper. If and when CDTFA is not satisfied with the
7 amount of tax reported on a person's returns, it may
8 compute and determine the tax required to be paid upon the
9 basis of any information within CDTFA's possession or that
10 may come into its possession, Revenue & Tax Code
11 section 6481. In this case, Notice of Determinations,
12 Exhibits B and H, were issued October 31st, 2022, for Copa
13 just for just over \$142,000 in tax, plus accrued interest
14 and penalties of approximately \$55,000; for Sundown,
15 approximately \$1.37 million in tax, plus accrued interest
16 and penalties of \$551,000.

17 As demonstrated in the Department's evasion
18 penalty recommendation memorandums, again, Exhibits C and
19 I, Appellants' millions of dollars of understatements for
20 the period were due to fraud or intent to evade sales and
21 use tax law: For Copa, an average percentage error of 83
22 percent for the period, roughly \$1.58 million in
23 unreported taxable sales divided by \$1.89 million that was
24 reported; for Sundown, an average percentage of error of
25 115 percent, roughly \$15.5 million in unreported taxable

1 sales divided by \$13.47 million that was reported.

2 The evidence clearly and convincingly shows that
3 Appellant had the requisite knowledge of the sales and use
4 tax law because they have long held seller's permits, are
5 experienced business persons who had been in the bar and
6 restaurant industry for many years. They had also been
7 provided with the requisite regulations, pamphlets, and
8 publications, and that Appellants demonstrated knowledge
9 and understanding of the law by charging sales tax
10 reimbursement on their sales. Appellants intentionally
11 evaded payment of a tax that they were aware was collected
12 but chose to report and pay a significantly lower amount.
13 Appellants had access to and knowledge of the correct
14 amounts from the point of sale software that repeatedly
15 reported a fraction of sales. Appellant collected and did
16 not pay over one-and-a-half million dollars in sales tax
17 over the liability periods.

18 Fraud, as held by Bradford versus Commissioner in
19 1986 is intentional wrongdoing on the part of a taxpayer
20 with a specific intent to avoid a tax known to be owing.
21 Fraud must be established by clear and convincing
22 evidence. Fraud may not be presumed, but it's rare to
23 find direct evidence that fraud has occurred. And so it's
24 often necessary to make the determination based on
25 circumstantial evidence.

1 As cited in the OTA precedential opinion, Appeal
2 of ISIF Madfish Incorporated, badges of fraud may include
3 understatement of income, inadequate records, failure to
4 file tax returns, implausible or inconsistent explanations
5 of behavior, concealment of assets, failure to corporate
6 with tax authorities, lack of credibility in the
7 taxpayer's testimony, falsified records, a substantial
8 discrepancy between recorded and reported amounts that
9 cannot be explained, and tax or tax reimbursement properly
10 charged evidencing knowledge of their requirements of law,
11 but not reported. As stated in Madfish, a finding that
12 any part of a deficiency determination was due to fraud is
13 sufficient to suspend the statute of limitations to issue
14 a deficiency determination as to the entire reporting
15 period in which any part of the deficiency was due to
16 fraud, Madfish page 9.

17 Let me take the time to apply those factors to
18 this case where we have significant understatements of
19 income of 83 and 115 percent respectively. No reasonable
20 explanation for the behavior and contrary filings between
21 government agencies. That is a difference of \$18 million
22 between the federal returns and those made to CDTFA
23 indicating an overt attempt to defraud the state by filing
24 false returns. Also, no explanation for the \$18 million
25 difference in bank deposit analysis indicative of

1 intentional underreporting.

2 The evidence shows that Appellants knowingly and
3 intentionally manipulated the sales tax amounts to evade
4 paying the correct amount of sales tax to the state.
5 Copies of the monthly and quarterly point-of-sale reports
6 were examined following execution of the search warrant.
7 The bottom of these reports display handwritten monthly
8 sales amounts which drastically differ from amounts
9 calculated by the point-of-sale report. The false
10 handwritten sales figures even display the method of a
11 manipulation as shown in Exhibit 14 of the evasion memos.
12 The correct tax was multiplied by 40 percent to determine
13 the amount of tax that was ultimately reported. Millions
14 of dollars in sales tax reimbursement was properly
15 collected from the customers at The Copa Room and
16 Tropicale, but not reported or remitted by Appellants.

17 Revenue & Taxation Code section 6485 imposes a
18 25 percent penalty if any part of a deficiency
19 determination was due to fraud or intent to evade the law
20 or authorized rules or regulations. The evidence before
21 us establishes that Appellants knowingly and consistently
22 understated their taxable sales and kept for their own use
23 over one-and-a-half million dollars in sales tax
24 reimbursement; again, for Copa, \$142,000 and Sundown,
25 \$1.37 million.

1 Appellant does not argue that the determination
2 is incorrect. Appellants' seized business and financial
3 records are the most reliable sources of information and
4 basis for this audit. Instead, they're claiming that the
5 determinations are not timely, as they are beyond the
6 three-year statute of limitations. However, there is no
7 statute of limitations when the underreporting was a
8 result of fraud or intent to evade the payment of tax, per
9 Revenue & Taxation Code section 6487. As held in the
10 precedential opinions of Landeros and Senehi, a Notice of
11 Determination is considered timely issued if the
12 Department can prove that Appellant intended to defraud
13 the state or evade the payment of tax for at least some
14 portion of each quarter of the liability period.

15 Appellants also contend that the application of
16 the 40 percent penalty, in lieu of the 25 percent penalty,
17 somehow negates the validity of the finding of fraud. The
18 Department does not double penalize. Revenue & Taxation
19 Code section 6487 suspends the statute of limitations when
20 fraud is found. Section 6485 and 6597 both state that the
21 penalties shall apply. The Department's Audit Manual
22 precludes the imposition of both the 25 percent fraud and
23 the 40 percent unremitted tax collected penalties on the
24 same tax. Therefore, the Department only applied the
25 40 percent penalty as applicable. This practice has been

1 approved by OTA in Senehi.

2 To carry Appellant's argument to its logical
3 application, it would result in a 65 percent penalty.
4 Revenue & Taxation Code section 6597 applies a 40 percent
5 penalty for knowingly collecting sales tax reimbursement
6 and not remitting it to the Department when the liability
7 for unremitted tax reimbursement averages a thousand
8 dollars or more a month for the reporting period and
9 exceeds 5 percent of the total tax collected. As
10 demonstrated on the evasion penalty memos, based on the
11 audit work papers, the evidence shows that the
12 requirements for imposition of the 40 percent penalty are
13 met for the periods. The average monthly unremitted
14 amounts far exceeded the applicable thresholds for the
15 liability periods. For Copa, as shown in the chart on
16 pages 8 and 9 of evasion memo, Exhibit I, an average
17 amount of over \$3,000 monthly was collected but not
18 remitted and a 44 percent average for the liability
19 period. For Sundown, as shown in the chart on page 8 of
20 evasion memo, Exhibit C, an average amount of over \$18,000
21 monthly was collected but not remitted and a 53 percent
22 average for the liability period.

23 Forty-percent penalties may be relieved, pursuant
24 to Revenue & Taxation Code section 6597
25 subdivisions (a)(2)(B), if the failure to make a timely

1 remittance of sales tax reimbursement is due to a
2 reasonable cause or circumstances beyond the person's
3 control, and occurred regardless of the person's exercise
4 of ordinary care, and in the absence of willful neglect.
5 Revenue & Taxation Code section 6597 subdivisions
6 (b) (1) (A) through (F) enumerates six examples of
7 reasonable cause or circumstances beyond the person's
8 control, none of which apply here.

9 There is no evidence of a credible explanation
10 for Appellants' failure to comply with the sales and use
11 tax reporting requirements and report the tax
12 reimbursement it had collected from its customers; no
13 showing of reasonable cause or circumstances beyond their
14 control. This was fraud. Also, based on the evidentiary
15 record and law, there are no adjustments warranted. The
16 audited amount of tax due is based on what the point of
17 sale records and investigation show Appellants collected
18 in tax reimbursement from its customers. The measures are
19 reasonable, grounded in fact, and rest upon the most
20 reliable of data available.

21 Lastly, Appellant claims that further relief of
22 interest is warranted based upon the delay caused by the
23 Department. The Department recommended and relieved five
24 months of interest. However, no other periods are
25 warranted. The criminal process is outside of the

1 Department's control. We submit to the panel that fraud
2 has been demonstrated by clear and convincing evidence, no
3 adjustments are warranted, and the penalty should be
4 upheld.

5 Thank you.

6 JUDGE LAMBERT: Thank you, Ms. Paley.

7 So now I'll turn to the panel to ask if they have
8 any questions.

9 Judge Kim, do you have any questions?

10 JUDGE KIM: I don't have any questions. Thank
11 you.

12 JUDGE LAMBERT: Thank you.

13 And, Judge Wong, do you have any questions?

14 JUDGE WONG: Yeah. I just had one question. I
15 would just ask if CDTFA's could address Mr. McClellan's
16 argument about 60 -- sorry -- 6485 about the fraud
17 penalty, his argument about the mandatory language that if
18 there is fraud that a penalty shall be added. I think you
19 touched on it, but I just want to give you a chance to
20 address it more specifically.

21 MS. PALEY: Yes. As indicated in my
22 presentation, both the 40 percent penalty and the
23 25 percent penalty indicate "shall". However, the
24 Department has policy of not double imposing. Again, to
25 carry his application out, it would result in a 65 percent

1 penalty, which we believe -- I mean, if Mr. McClellan
2 would like that imposed, we can impose that. But I
3 believe it is to his client's benefit to have the
4 40 percent applied in lieu. Also -- also, it would
5 indicate that Senehi upheld that process and it is a
6 precedential opinion.

7 JUDGE WONG: Thank you. Okay, so it's CDTFA's
8 policy. Is there any other authority aside from that for
9 why CDTFA doesn't double impose, let's say, the 25 percent
10 fraud penalty and the 40 percent penalty, or is it just
11 kind of an internal policy? It's in the Audit Manual such
12 a --

13 MS. PALEY: The Audit Manual indicates that we
14 shall not double impose.

15 JUDGE WONG: Okay. Thank you. That's all the
16 questions I had.

17 JUDGE LAMBERT: Thank you.

18 I had a question. I think CDTFA could -- or
19 Ms. Paley, could you clarify? So in Sundown, there was no
20 fraud penalty, but there is one in Copa Room. And in Copa
21 Room there's also the 40 percent penalty. So maybe could
22 you just clarify the reason why there is one penalty in
23 one case, but not in the other. And I think for one,
24 Sundown, is because there's no duplication, but just to
25 clarify what happened in The Copa Room.

1 MS. PALEY: Yes. And I'll let Ms. Candelaria
2 address that specific.

3 MS. CANDELARIA: Okay. So, basically for Copa,
4 the tax it collected was less taxes that was due based on
5 taxable sales. So the 40 percent could only be applied to
6 the tax collected, and then 25 percent was applied to the
7 balance. But for Sundown, the tax collected was more than
8 the tax due based on taxable sales. So we just picked up
9 the tax collected, and the entire amount was subject to
10 40 percent because it was collected tax.

11 JUDGE LAMBERT: Thank you. So in that case,
12 there was no duplication because they were assessed on
13 different -- imposed on different amounts?

14 MS. CANDELARIA: Yeah. Yeah. So the total
15 penalties applied to the total -- it didn't exceed the
16 total tax. So yeah. So for Sundown it was just applied
17 40 percent the entire amount, while Copa was 40 percent to
18 the tax collected, and then 25 percent for the additional
19 taxes due based on taxable sales.

20 JUDGE LAMBERT: Okay. Thank you. Thank you,
21 Ms. Candelaria and Ms. Paley.

22 And I just had a -- for Appellants, I just had a
23 follow-up question. I was wondering if there's any, in
24 terms of the order to destroy or return evidence, was
25 there any action taken legally if CDTF was in violation

1 of the order in order to get them to destroy it or return
2 the evidence?

3 MS. PALEY: I know of none.

4 JUDGE LAMBERT: And Appellants? Mr. McClellan or
5 Ms. Kay?

6 MS. KAY: Well the -- so when something is seized
7 pursuant to a search warrant that falls under the Penal
8 Code section 1526, and it's a judicial officer who
9 holds -- holds those items for the court because it's a
10 judicial order they allow to get the search warrant. Once
11 the motion was filed and the judge says return and/or
12 destroy, that is the plain letter. Like, it belongs with
13 the investigative officer. That's who holds the property,
14 and they're to return and/or destroy it. They are not to
15 disseminate that, even if it is the CDTFA.

16 It's -- for example, if the Attorney General's
17 Office has a search warrant in their investigative
18 Department, and it's for, you know, potential medical
19 records that's going to maybe go to the Medical Board for
20 an administrative hearing, they can't just -- once a
21 criminal case is over, they can't just take those records
22 and slide them on over to the Medical Board for the
23 administrative hearing. That's not what those records are
24 for. They were for a very specific purpose, for a very
25 specific purpose only; and the Penal Code dictates that as

1 does a Superior Court judge when they return that. Can't
2 disseminate that information.

3 JUDGE LAMBERT: Thank you. I guess I was
4 specifically wondering, if there are some alleged
5 violation of an order, if any action was taken, you know,
6 to rectify the situation legally.

7 MS. KAY: Oh, because -- because the CDTFA is
8 using it? That is -- that is part of what the issue is
9 here. And if we have to go to Superior Court, that will
10 definitely be an issue, that it was a violation to
11 continue to use documents that were part of a criminal
12 case that were returned.

13 JUDGE LAMBERT: Okay. Thank you.

14 So at this time, Mr. McClellan, Ms. Kay, you
15 could make your closing remarks for 10 minutes, and you
16 can proceed when you're ready.

17 MR. MCCLELLAN: Yeah. If I may, I'll go ahead
18 and make some closing and responsive remarks, then I'll
19 turn it over to Ms. Kay.

20

21 CLOSING STATEMENT

22 MR. MCCLELLAN: Just a point that is more in
23 Ms. Kay's side of this case, but I believe CDTFA's
24 representative did sign a document confirming that the
25 records were returned or destroyed. And so, ultimately,

1 that document confirms that CDTFA doesn't actually have
2 possession or, at least, legal possession of the evidence
3 upon which they allegedly rely.

4 Just to go back to CDTFA's presentation, frankly,
5 it's a little confusing because CDTFA opened by supporting
6 its basis through Code section 6485. And I think this
7 goes to what happens when there's a reading of the law in
8 isolation or in a vacuum without treating the entire body
9 of law as being applicable. Now, I spoke at length for
10 the reasons why. It's all in the record. Of course, I
11 can answer any questions in that regard, but 6485 is
12 explicit in its language that if -- if there's a finding
13 of fraud, that the penalty shall be added to the
14 deficiency determination. 6487's language mirrors that
15 language in establishing that the statute of limitations
16 will be suspended in the case of a finding of fraud or
17 intent to -- to evade under rules and regulations. It's
18 the same language. It has to be read together. And --
19 and, ultimately, if a fraud penalty is not assessed,
20 respectfully, CDTFA can suspend a statute of limitations.

21 Now, they suggested that the approach that we've
22 argued today would result in a 65 percent penalty while
23 simultaneously acknowledging that CDTFA has policy
24 directly against that. And so I don't know why it would
25 result in a 65 percent penalty. I think the suggestion

1 that it would is disingenuous. Now, ultimately, as it
2 pertains to an analysis of the law, I think the -- the
3 conclusion that they both cannot apply is appropriate; and
4 to the extent that you put those two sections together,
5 and it's unclear as to what CDTFA ought to do.

6 And, of course, they can go to the legislative
7 record. If they find an ambiguity between the two
8 sections in what they're supposed to do, they can go to
9 the legislative record. And, of course, CDTFA was -- was
10 involved at that time. The Board of Equalization was very
11 much involved in the passage of 6597. It was sponsored by
12 a Board member. And the record is clear that it wasn't
13 intended to be an additional penalty in the case of fraud,
14 which, essentially, they're using as a defense to saying
15 that we only applied a 40 percent penalty. We think that
16 is disingenuous. I mean, to say it only applied the
17 higher of the two penalties, frankly, I don't see as being
18 authentic.

19 To the extent that there's discretion that
20 exists, and -- and to the extent CDTFA has authority to
21 assess a fraud penalty or a 40 percent penalty, then they
22 can, I suppose, exercise that discretion. But they don't
23 get to, if they assess a 40 percent penalty, suspend the
24 statute of limitations, unless the mechanism by which that
25 statute of limitations is capable of being suspended is

1 followed. And the law very clearly says that it's only
2 suspended where the deficiency determination, so the
3 Notice of Determination that's issued, has a penalty
4 that's added. That conclusion, we would submit, is
5 inescapable if you read 6487 and 6485 in conjunction with
6 each other as rules of construction mandates.

7 So just to clarify and just to make clear, we're
8 not suggesting that CDTFA would have to assess 65 percent
9 on other taxpayer's going forth in order to adhere with
10 the law. Again, CDTFA recognizes that's not the case.
11 They have policy on that. They can choose one penalty or
12 the other. What they can't do is assess a 40 percent
13 penalty and then use fraud as a basis to suspend the
14 statute of limitations, open the periods that are
15 available, and then maximize revenue by assessing
16 40 percent. I think, ultimately, that's what they -- they
17 sought to do here. To suggest that they -- they took a
18 more on conservative approach, I think, is disingenuous.

19 Bear with me. I want to -- one -- one other
20 factor that I -- that I think warrants addressing is the
21 suggestion that there's -- there's not been an explanation
22 provided by Appellant in this case. To be clear, CDTFA
23 carries the burden of proof. Now, we have a little bit of
24 complexity here because, ultimately, fraud wasn't
25 assessed. But, clearly, CDTFA is relying upon fraud,

1 notwithstanding its absence of assessing the penalty,
2 recognizing that if it doesn't, then the statute of
3 limitations have expired. We think that it's,
4 essentially, subverted the code in order to reach the
5 result that it wants.

6 And -- and to suggest that fraud is supported,
7 absent an explanation, is not a valid legal concept where,
8 in this case, the Department bears the burden of proof.
9 To help put that in context, of course, it would never be
10 suggested that a liability must be canceled because a
11 taxpayer comes before OTA and argues that CDTFA's
12 explanation has been insufficient where the taxpayer bears
13 the burden of proof, even in preponderance of the evidence
14 cases; which is, primarily, what exist outside of fraud
15 for purposes of liability. The same concept applies here
16 when the shoe is on the other foot. CDTFA bears the
17 burden of proof to establish fraud by clear and convincing
18 evidence. We maintain that it has not. And we think that
19 one piece of evidence that is significantly persuasive is
20 the fact that CDTFA and Mr. Di Lembo, clearly, isn't
21 privity, by the way, with these corporations. CDTFA is in
22 privity with the DA's office. They both represent
23 California. That goes to res judicata. But, ultimately,
24 they went through a similar proceeding as this, if you
25 will, for five days. And if -- if we wanted to sit here

1 for five days and tear down CDTFA's purported evidence to
2 support fraud, then -- then that would be something that I
3 suppose that we can engage in.

4 Ultimately, under the circumstances, we think
5 it's best to establish that fraud has never been assessed,
6 and that's been the focus of our argument. But -- but,
7 certainly, there are reasons that there is -- that fraud
8 is not supported. That's already been established by the
9 courts. And suggesting that it's somehow supported
10 because there's not been an explanation, we think, is
11 invalid.

12 JUDGE LAMBERT: Okay. Is that it?

13 MR. MCCLELLAN: Just going through my notes.

14 JUDGE LAMBERT: Okay.

15 MR. MCCLELLAN: One of the things I would -- I
16 would submit that CDTFA has not presented in their
17 evidence is that there was collection of tax under
18 Regulation 1700 as it pertained to bar sales. The bar
19 sales were made on a lump sum basis. And under Regulation
20 1700 and Civil Code 1656.1 and related CDTFA annotations,
21 in order to establish the tax was collected, there must be
22 clear notice. Another thing that's left out of the
23 analysis are cover charges. Another thing that's left out
24 of the analysis is cold food to go, all of which is not
25 subject to tax; and all of which create confusion in these

1 operations in the related reports.

2 Bear with me just one moment. With that, I don't
3 have anything further to add. I'll turn it over to
4 Ms. Kay, if -- if she has any comments further to make.

5 MS. KAY: I think you did hit on the issue
6 with -- with privity. I mean, there are cases that are on
7 point, I think, we're in our brief but People v Simms,
8 Sotterling v Office of the Attorney General, and Zapata
9 versus the DMV. There is privity between the CDTFA and
10 the District Attorney's Office. There is privity between
11 Tony Di Lembo and Sundown and Copa as an officer of the
12 company. So when you look at res judicata and collateral
13 estoppel issues, all of those elements have been met. You
14 -- you need to look at them closely to determine who are
15 the people? Who would the witnesses be? The CDTFA people
16 would be the same witnesses.

17 It would be the same issues. While one is a
18 Penal Code section and the other are not, you look at the
19 elements of those, and they have the same elements. So
20 you are addressing the same issues in a different form,
21 and there was a final result, final judgment at the
22 preliminary hearing. So to go further here, they should
23 be barred based on res judicata and the collateral
24 estoppel.

25 MR. MCCLELLAN: And, Ms. Kay, before you wrap up,

1 I'd -- your comments did trigger just something that I
2 would like to add.

3 In CDTF's presentation, they pointed out that
4 this case is brought under 6485. Again, just saying that
5 spikes confusion in my mind because, of course, they've
6 not actually assessed a penalty or adhere to the plain
7 language of 6485. But to the point that Ms. Kay made, as
8 it pertains to res judicata and collateral estoppel, the
9 authority that's cited in the briefs makes it sufficiently
10 clear to establish that, so long as the same or similar
11 issues are being addressed, then it's sufficient to apply.
12 I think it's -- well, to suggest that just because there's
13 different Code sections that -- that both address fraud,
14 that in those situations there -- there wouldn't be
15 qualification, is not a valid legal position.

16 Generally speaking, when you get into these
17 scenarios that pertain to criminal versus civil, the issue
18 is that in the criminal proceeding there's a higher
19 standard of proof, but, in this case, that's not present.
20 Because at the preliminary hearing stage, the standard of
21 proof was actually lower than it is at this proceeding;
22 which for purposes of fraud in this proceeding, it's clear
23 and convincing evidence. Whereas, the standard of proof
24 for purposes of the preliminary hearing was preponderance
25 or was -- or something lower than that. So ultimately --

1 JUDGE LAMBERT: Mr. McClellan, you can -- if you
2 can, you can wrap up. Are you able to wrap it up in a
3 little bit, you think?

4 MR. MCCLELLAN: Yeah. I'm sorry that we -- I
5 thought we were provided with -- with three hours of time,
6 Judge Lambert. We're --

7 JUDGE LAMBERT: Oh, okay.

8 MR. MCCLELLAN: Are we -- are we pushing against
9 that?

10 JUDGE LAMBERT: You wanted to add time you didn't
11 use to your closing? So is that what you're saying?

12 MR. MCCLELLAN: Yeah. I -- I just thought that
13 we were provided with three hours of time. I didn't know
14 that we were up against that.

15 JUDGE LAMBERT: Actually, two hours for your
16 presentation and then closing remarks for 10 minutes. So
17 that was what we had stated -- not three hours. But if
18 you want on go on longer because you didn't use up some of
19 your time during your opening presentation, you could do
20 that.

21 MR. MCCLELLAN: I appreciate that.

22 JUDGE LAMBERT: And just to clarify, do you think
23 you'll be going on for, like, an hour now?

24 MR. MCCLELLAN: Absolutely not.

25 JUDGE LAMBERT: Okay. I was just checking so I

1 can keep track of what's going on.

2 MR. MCCLELLAN: Fair question. I respect that
3 this has been going along and lot has been said, but I --
4 I just want to make sure that these basis are covered and
5 not something that's overlooked. In closing, I would say
6 that res judicata, we believe, absolutely can apply in
7 these situations, that OTA has found that -- that it
8 applies in proceedings with the Board of Equalization and
9 in proceedings with OTA that are -- that are at a much
10 lower level, if you will, as it pertains to the scope of
11 the proceedings that occurred. And we would just
12 respectfully again, request that OTA give due
13 consideration in its deliberation, and in its opinion to
14 the arguments, and to the specific language of Code
15 section 6485, in particular, in the opinion.

16 And in reading Senehi, for example, Code 6485
17 isn't quoted at all. And so there's -- there's no real
18 discussion about whether or not CDTFA can adhere to Code
19 section 6485, as I think we would all agree it must, where
20 it says it shall be added, and if it's not, and ultimately
21 how that works in conjunction with 6487 under the rules of
22 statutory construction which require those Code sections
23 to be read together and not in isolation.

24 And with that, I have nothing further.

25 JUDGE LAMBERT: Okay. Thank you, Mr. McClellan

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and Ms. Kay.

So if there's nothing further, I'm going to
conclude the hearing. I want to thank both parties for
appearing today.

And we will issue a written opinion within
100 days.

Thank you, and the record is now closed.

(Proceedings concluded at 2:59 p.m.)

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I, Ernalyne M. Alonzo, Hearing Reporter in and for
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I have hereunto subscribed my name this 6th day
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