

CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION BOARD HEARING SUMMARY

In the Matter of the Petition for Redetermination)
Under the Sales and Use Tax Law of:)

ROCKS, LLC)

Petitioner)

Account Number SR GH 97-290208

Case ID 459156

Santa Barbara, Santa Barbara County

Type of Business: Restaurant and bar

Audit period: 05/01/98 – 03/31/07

<u>Item</u>	<u>Disputed Amount</u>
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Unreported taxable sales	\$4,154,007 ¹
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Fraud penalty	\$ 149,030
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	<u>Tax</u>	<u>Penalty</u>
As determined and proposed to be redetermined	\$596,119.60	\$214,254.50
Less concurred	- 273,576.67	- 65,224.53 ²
Balance, protested	<u>\$322,542.93</u>	<u>\$149,029.97</u>
Proposed tax redetermination	\$ 596,119.60	
Interest through 12/31/15	588,901.32	
Fraud penalty	149,029.97	
Amnesty double fraud penalty	65,224.53	
Amnesty interest penalty	<u>50,676.10</u>	
Total tax, interest, and penalty	\$1,449,951.52	
Payments	- 22,314.03	
Balance Due	<u>\$1,427,637.49</u>	
Monthly interest beginning 01/01/16	<u>\$ 2,869.03</u>	

This matter was scheduled for Board hearing in December 2012, but was deferred at the request of the Appeals Division in order to issue a Supplemental D&R. It was rescheduled for Board hearing

¹ The disputed amount of unreported taxable sales is estimated. Petitioner asserts that 20 to 30 percent of its sales are exempt sales of cold food to go. Accordingly, we have computed the disputed amount of the audited understatement by applying 30 percent to audited total sales of \$13,846,689.

² Petitioner specifically stated at the second conference that it was not protesting the imposition of the amnesty penalties (the amnesty double fraud penalty of \$65,224.53 and the amnesty interest penalty of \$50,676.10 that will be added when the liability becomes final). Although petitioner stated that it might separately address the amnesty penalties at a later time, it has not done so. Accordingly, we regard the amnesty penalties as undisputed. However, we note that, if petitioner prevails regarding the application of the fraud penalty, and that penalty is deleted from the liability, the amnesty-double fraud penalty will also be deleted.

1 in November 2013 and December 2013, but was postponed both times at petitioner's request to allow
2 additional time to prepare. It was rescheduled in January 2014 but was postponed for settlement
3 consideration.

4 UNRESOLVED ISSUES

5 **Issue 1:** Whether adjustments are warranted to the amount of unreported taxable sales. We
6 find no adjustment is warranted.

7 Petitioner operated an up-scale restaurant and bar from May 1998 through October 2008. For
8 audit, petitioner provided federal income tax returns, sales and use tax returns, financial statements,
9 and general ledgers and other related journals. The Department used the amounts reported on
10 petitioner's California income tax returns for the period May 1, 1998, through December 31, 2003, and
11 recorded sales from its profit and loss statements and general ledger for the period May 1, 1998,
12 through March 31, 2007, to compile recorded total sales of \$13,846,869. The Department compared
13 that total to the amounts of total sales reported on sales and use tax returns of \$6,169,464, to compute
14 unreported taxable sales of \$7,677,405.³

15 Petitioner contends an adjustment is warranted for exempt sales of cold food to go, and
16 estimates the amount of exempt sales at 20 to 30 percent of total sales. As evidence of exempt sales of
17 cold food to go, petitioner has provided an affidavit from a manager of Smart & Final stating that
18 petitioner purchased large quantities of "to go" containers, an affidavit from one of the members of the
19 LLC stating that she did not believe all of petitioner's sales were taxable, and receipts for "to go"
20 containers and for purchases of canned soft drinks. Although petitioner concedes that it used
21 containers to package leftovers for customers dining at the restaurant, it asserts that it also consistently
22 used containers for "to go" orders. Petitioner states that its location was in the heart of Santa Barbara,
23 near parks and the beach, arguing that it is logical to assume, based on the location, that it made sales
24

25 ³ The Department noted that petitioner had claimed deductions for sales tax included and bad debts totaling \$9,221 for the
26 second quarter of 1998 and the first and third quarters of 1999. If the Department had concluded that those deductions were
27 inappropriate, it would have regarded all recorded total sales as taxable and would have computed the understatement by
28 comparing recorded total sales with reported taxable sales. However, the Department computed the understatement by
comparing recorded and reported total sales. Since the Department did not include the \$9,221 as additional taxable sales, it
effectively accepted petitioner's claimed deductions.

1 of cold food “to go.” Also, petitioner cites the large volume of purchases of canned soft drinks as
2 evidence of sales “to go,” since it purportedly did not serve canned soft drinks in the restaurant.

3 Petitioner did not claim any exempt sales of food on its sales and use tax returns. Also, the
4 amount of sales tax accrued corresponded exactly with petitioner’s recorded taxable sales, which
5 indicates that sales tax reimbursement was collected on all of its sales and that petitioner regarded all
6 sales as taxable. In addition, petitioner’s recorded sales were in general agreement with the amounts
7 reported on its income tax returns. The only reports that indicated a different amount of taxable sales
8 were petitioner’s sales and use tax returns, which reported substantially less in total sales than were
9 recorded or were reported for income tax purposes. Further, the auditor indicated that he did not
10 observe any sales of cold food “to go” during his visit to the restaurant, and he did not observe any “to
11 go” signage, paper “take out” menus, separate guest checks, or “to go” order forms during his visit to
12 the restaurant. Moreover, in our own Internet research, we found 60 customer reviews and none of
13 them mentioned any purchase of food “to go.” We find that petitioner’s purchases of “to go”
14 containers and canned soda do not represent persuasive evidence of sales “to go,” let alone sales of
15 cold food “to go.” Accordingly, we conclude that petitioner has not provided adequate evidence to
16 support an adjustment for exempt sales of cold food “to go.”

17 **Issue 2:** Whether the Department has established fraud by clear and convincing evidence.⁴ We
18 find that the Department has.

19 The Department imposed the fraud penalty for several reasons, including: 1) petitioner’s
20 members, who were experienced in preparing sales and use tax returns, maintained the books and
21 records; 2) petitioner’s recorded sales and gross receipts reported on income tax returns were
22 substantially greater than the amounts reported on its sales and use tax returns; 3) petitioner reported
23 on its federal statements that its liability for sales tax payable increased during 2004 by \$120,890 (from
24 \$54,738 to \$175,268), indicating that petitioner’s sales tax liability for 2004 was at least \$120,890, but
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26 ⁴ Without regard to whether the finding of fraud is upheld, the Notice of Determination was timely issued for the period
27 July 1, 2001, through December 31, 2002, under the under the 10-year statute of limitations (Rev. and Tax. Code § 7073,
28 subd. (d)), and was timely issued for the period April 1, 2005, through March 31, 2007, under the 3-year statute of
limitations (Rev. and Tax. Code § 6487, subd. (a)). Absent a finding of fraud, the determination would not have been
timely for the periods May 1, 1998, through June 30, 2001, and January 1, 2003, through March 31, 2005.

1 it paid only \$36,603 in tax to the Board for that year; 4) according to the Department, petitioner had
2 made statements during the audit that demonstrated knowledge of the underreporting; and 5) the
3 understatement throughout the audit period was substantial, with an overall percentage of error of 125
4 percent.

5 Petitioner protests the fraud penalty on the basis that a material audit adjustment is warranted
6 for exempt sales of cold food to go and that fraud has not been established by clear and convincing
7 evidence. Essentially, petitioner argues that the evidence of fraud is not clear and convincing because
8 the understatement was not intentional, stating that it did not realize sales of cold food to go are
9 exempt from tax and that tax reimbursement was not included in its bar sales or to go sales. In
10 addition, petitioner disavows statements made by one of its members, Ms. Donoviel, during the audit,
11 which the Department argues were clear evidence that she was aware petitioner was underreporting its
12 sales on sales and use tax returns.⁵

13 As explained under Issue 1, petitioner has not provided sufficient evidence to establish material
14 amounts of exempt sales of cold food to go. Accordingly, we reject that element of petitioner's
15 arguments related to the fraud penalty.

16 Regarding petitioner's argument that sales tax reimbursement was not included in its bar sales,
17 we note (and petitioner understands) that, if we accepted this assertion, the understatement of tax
18 would increase. However, petitioner claims that the difference between sales tax reimbursement
19 collected and sales tax paid would decrease, thus rendering the Department's arguments regarding
20 fraud less persuasive. Petitioner notes that there was no sign in the bar stating that the sales included
21 sales tax reimbursement. Further, petitioner asserts that, in cases involving fraud, the Department
22 bears the burden of proving each fact (including whether the bar sales included tax reimbursement) by
23 clear and convincing evidence. First, while the Department must prove fraud, as a whole, by clear and
24 convincing evidence, we find that standard of proof is not applicable to each single fact used to
25 establish fraud. The parties agree that the Department routinely accepts that tax reimbursement is
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27 ⁵ Petitioner also has argued that the fraud penalty should not be imposed because the auditor initially made a determination
28 that petitioner was negligent, but not fraudulent. We note that this argument bears virtually no weight, and we will not
discuss it further herein.

Regarding the issue of whether Ms. Donoviel made certain statements to the Department during the audit, we find that there is ample evidence of fraud whether or not Ms. Donoviel told the auditor that she knew the sales reported on sales and use tax returns were understated. As stated previously, audited sales were based on amounts reported on petitioner's California income tax returns for the period May 1, 1998, through December 31, 2003, and recorded sales from its profit and loss statements and general ledger for the period May 1, 1998, through March 31, 2007. In other words, the entire understatement of \$7,677,045, which represents an understatement of 125 percent in comparison to reported taxable sales of \$6,160,243, represents a difference between recorded and reported sales. Moreover, petitioner reported the correct amount of sales for income tax purposes. Thus, it is clear that petitioner knew the amount of sales that were made but reported substantially lower amounts on its sales and use tax returns.

Based on all the foregoing, we find that the evidence establishes to a clear and convincing degree that petitioner fraudulently failed to report its taxable sales for the audit period and that it collected sales tax reimbursement that it failed to remit to the Board. Therefore, we conclude that the fraud penalty was properly imposed.

None.

Summary prepared by Deborah A. Cumins, Business Taxes Specialist III