

1 CALIFORNIA STATE BOARD OF EQUALIZATION

2 APPEALS DIVISION BOARD HEARING SUMMARY

3 In the Matter of the Petition for Redetermination)
 4 Under the Sales and Use Tax Law of:)
 5 WALID KHALED AWWAD,) Account Number: SR GH 97-713716
 6 dba Wienerschnitzel #29) Case ID 512991
 7 Petitioner) Santa Clara, Santa Clara County

8 Type of Business: Fast food restaurant

9 Audit period: 1/1/01 – 3/31/08

10 Item Disputed Amount

11 Fraud penalty \$44,569
 12 Tax collected but not remitted penalty \$20,163

	<u>Tax</u>	<u>Penalties</u>
13 As determined	\$228,681.75	\$71,963.63
14 Less concurred	-228,681.75	0.00
15 Balance, protested	<u>\$ 0.00</u>	<u>\$71,963.63</u>

16 Proposed tax redetermination	\$228,681.75
17 Interest through 11/30/12	141,037.58
18 Fraud penalty	44,568.65
19 Tax collected but not remitted penalty	20,162.96
20 Amnesty double fraud penalty	7,232.02
21 Amnesty interest penalty	<u>3,460.90</u>
22 Total tax, interest, and penalties	<u>\$445,143.86</u>
23 Monthly interest beginning 12/1/12	<u>\$1,143.41</u>

21 **UNRESOLVED ISSUES**

22 **Issue 1:** Whether the Department has established fraud by clear and convincing evidence.¹ We
 23 conclude that it has.

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 25 ¹ Without regard to whether the finding of fraud is upheld, since petitioner did not participate in the amnesty program, the
 26 determination is timely for the period July 1, 2001, through December 31, 2002, under the 10-year amnesty statute of
 27 limitations. (Rev. and Tax. Code § 7073, subd. (d).) The determination is also timely for the period April 1, 2005, through
 28 March 31, 2008, under the general 3-year statute of limitations because the Notice of Determination was issued within the
 period authorized by waivers signed by petitioner. (Rev. & Tax. Code, §§ 6487, subd. (a), 6488.). The determination is
 timely for the periods January 1, 2001, through June 30, 2001, and January 1, 2003, through March 31, 2005, only if the
 finding of fraud is upheld.

1 The Sales and Use Tax Department (Department) imposed the 25 percent fraud penalty for the
2 period January 1, 2001, through December 31, 2006, because petitioner reported only about one-third
3 of his recorded taxable sales on his sales tax returns.² The Department concluded that petitioner had
4 knowledge of the reporting requirements,³ had knowledge of the applicable tax laws,⁴ and had
5 knowledge of his correct sales amounts,⁵ but chose to disregard the sales tax returns prepared by his
6 accountant from his own books and records and instead file his own sales tax returns.

7 Petitioner contends that: the Department's reliance on the gross receipts reported on the federal
8 income tax returns is not enough evidence to prove fraud; he was defrauded by his store manager who
9 he asserts forged and filed erroneous sales tax returns; he was not at the business on a regular basis and
10 did not benefit financially; and the Department has not proven petitioner's intent to evade the tax.

11 Preliminarily, we note that petitioner knew of his tax compliance and reporting obligations,⁶
12 calculated and charged the proper amount of tax reimbursement, and consistently filed tax returns. We
13 find that petitioner knew of his correct tax liability,⁷ but chose to file sales tax returns that substantially
14 underreported his sales. This is strong evidence of intent to evade tax due.

15 With respect to petitioner's allegation that the store manager forged returns, during the appeals
16 conference we asked petitioner's representative how that was possible considering that petitioner's
17 accountant mailed returns he had prepared to petitioner's home address. Although he indicated that he
18 would provide an explanation at a later date, he has not done so. Based on our review of the file and
19 the lack of any evidence in support of the allegation, we conclude that there were no such forgeries.

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21 ² The \$3,304,145 gross receipts that petitioner had recorded on his cash register z-tapes, monthly sales summaries, detail
22 trial balances, P&L's, and federal income tax returns for 2001 through 2006, exceeded the \$1,143,246 total sales that he
23 reported on his sales and use tax returns by \$2,160,899, representing a 189 percent underreporting error rate when
24 compared with reported taxable sales.

25 ³ Petitioner began operations in June 2000, yet the taxable sales understatements and resulting error ratios (based on
26 comparisons of unreported taxable sales with reported taxable sales) increased significantly in each succeeding year -
27 \$130,312 (54.51 percent) for 2001, \$220,329 (104.36 percent) for 2002, \$459,447 (136.53 percent) for 2003, \$413,934
28 (273.50 percent) for 2004, \$449,291 (428.87 percent) for 2005, and \$487,586 (485.53 percent) for 2006.

⁴ Petitioner collected the proper amount of sales tax reimbursement and recorded those amounts on his cash register z-tapes,
monthly sales summaries, and sales tax payable account.

⁵ The correct sales amounts were reported on federal income tax returns and sales tax returns prepared by petitioner's
accountant for 2001 through 2006.

⁶ As a permitted seller, petitioner received Tax Information Bulletins. Further, his seller's permit application indicates he
received copies of Board publications relevant to the dining and beverage industry.

⁷ Petitioner maintained accurate books and records, and his accountant prepared sales tax returns based on those records
listing the correct sales tax liability thereon.

1 Rather, we find petitioner himself is responsible for the returns which substantially underreported the
2 tax due. (See also Audit Manual § 0509.40.) We find that the \$2,160,899 taxable sales understatement
3 for the period January 1, 2001, through December 31, 2006, representing a 189 percent reporting error
4 rate, is significantly large and is additional evidence of fraud. We note also that petitioner has never
5 asserted that the income and sales tax returns prepared by his accountant were incorrect. We conclude
6 that the Department has established by clear and convincing evidence that the understatement was due
7 to petitioner's fraud.

8 **Issue 2:** Whether the 40 percent penalty for tax reimbursement collected and not timely
9 remitted as sales tax was properly imposed. We conclude that the penalty was properly imposed.

10 The Department imposed the 40 percent penalty for tax collected and not timely remitted for
11 the period January 1, 2007, through March 31, 2008, because it found for this period that petitioner
12 collected \$50,407 more tax reimbursement than it paid to the Board, his unreported tax averaged over
13 \$1,000 per month, and his unreported tax is more than five percent of the total tax due. Petitioner
14 contends that the 40 percent penalty is an evasion penalty, and that two evasion penalties cannot be
15 imposed in the same determination, citing Business Taxes Law Guide annotation 320.0133 (5/19/86).
16 Petitioner also argues that he lacked intent to evade the tax and that he did not benefit financially
17 during this period, so the 40 percent penalty is not warranted.

18 Annotation 320.0133 stands for the proposition that two fraud penalties will not be imposed on
19 the very same tax. Here, the 25 percent fraud penalty was imposed on petitioner's fraudulent conduct
20 through 2006, and the 40 percent penalty was imposed for petitioner's failure to remit tax
21 reimbursement collected on and after January 1, 2007. Therefore, even if the 40 percent penalty were
22 an evasion penalty as petitioner asserts, the imposition of the penalty does not violate the underlying
23 concept of the annotation. Furthermore, the 40 percent penalty is, on its face, *not* an evasion penalty.

24 The 40 percent penalty is imposed by Revenue and Taxation Code section 6597. The very
25 purpose for the Legislature's adoption of section 6597 was to impose the 40 percent penalty based on
26 the specific elements laid out in the statute (i.e., knowing collection of sales tax reimbursement and the
27 failure to remit such amounts as sales tax to the Board in excess of a specified threshold) in lieu of
28 imposing a fraud penalty that would have to be established by clear and convincing evidence. Indeed,

1 subdivision (a)(2)(B) of section 6597 provides that the otherwise applicable 40 percent penalty will be
2 relieved if the taxpayer's failure to timely remit the sales tax reimbursement as sales tax is due to a
3 reasonable cause or circumstances beyond the taxpayer's control, and occurred notwithstanding the
4 exercise of ordinary care and the absence of willful neglect. If the 40 percent penalty could be
5 imposed only on a showing of fraud or evasion, the relief provision would be meaningless surplusage
6 since it is not possible to show that a failure occurred notwithstanding the exercise of ordinary care and
7 in the absence of willful neglect when it has been established by clear and convincing evidence that the
8 failure was the result of fraud. We conclude that the 40 percent penalty is not an evasion penalty, but
9 rather a severe negligence penalty (which may, of course, be applicable in situations where fraud could
10 be established by clear and convincing evidence, as we believe is the case here).

11 We acknowledge that our conclusion contradicts the Department's characterization of the 40
12 percent penalty in Chapter 5 of the Board's Audit Manual and in Operations Memo 1148, where it
13 identifies the penalty as an evasion penalty. However, there is a valid basis to treat it as an evasion-
14 type penalty in some respects. The 40 percent penalty was intended to apply in certain circumstances
15 where the fraud penalty is often warranted. That is, as noted above, it was intended to relieve the
16 Department of the need to prove fraud by clear and convincing evidence if the facts come within the
17 provisions of section 6597, even if the fraud penalty could otherwise be imposed. So, where the facts
18 come within section 6597 and also appear to support imposition of the fraud penalty by clear and
19 convincing evidence, we believe it is appropriate to treat the 40 percent penalty as an evasion-type
20 penalty so that both penalties are not imposed on the *very same liability*. Here, although the
21 Department was confident it could establish fraud for the entire audit period and could have imposed
22 the fraud penalty and the section 6597 penalty on the same tax liability, it did not do so, instead
23 applying the 25 percent fraud penalty and the 40 percent failure-to-remittance penalty to separate periods
24 without any overlap. This complies completely with the wording and intent of annotation 320.0133.
25 We believe it also complies with the intent of section 6597, which was intended as an easier to impose
26 *substitute* for the fraud penalty, although written in terms of a negligence penalty (penalty remains
27 applicable unless taxpayer shows it was not negligent).

1 We conclude that the section 6597 penalty was properly imposed, and that, since petitioner was
2 more than negligent, there is no basis for relief.

3 **OTHER MATTERS**

4 Since petitioner failed to participate in the amnesty program, an amnesty double fraud penalty
5 of \$7,232 was assessed for the period January 1, 2001, through December 31, 2002, and an amnesty
6 interest penalty of \$3,461 will apply when the tax becomes final. During the appeals process,
7 petitioner was informed of the relief provisions and given the opportunity to file a request for relief of
8 the amnesty penalties, but he stated that he did not wish to do so. Therefore, we have no basis on
9 which to consider recommending relief of the amnesty penalties.

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11 Summary prepared by Pete Lee, Business Taxes Specialist II
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