

1 the NOD was issued subsequent to the end of the amnesty period. (Rev. & Tax. Code § 7073, subd.
2 (d).) The Board has determined that this 10-year statute of limitations applies only to reporting periods
3 for which the standard, *non-amnesty* statute of limitations had not expired as of August 16, 2004, the
4 effective date of the amnesty legislation. In this case, that period is July 1, 2001, through
5 December 31, 2002. Thus, if the finding of fraud were not upheld, we would conclude that the NOD
6 was not timely for the period prior to July 1, 2001.

7 In an RFR, Ms. Gordon protested our conclusion regarding the timeliness of the NOD issued to
8 her, reiterating her contention that the Department has not proven fraud for any portion of the audit
9 period. In that regard, petitioner asserts that the finding of fraud by the sole proprietorship was based
10 solely on the findings of the audit of the corporation. Petitioner further asserts that, if the 10-year
11 statute of limitations is applied, the NOD was timely only for the period beginning October 1, 2001.

12 With respect to petitioner's assertion that the finding of fraud on the part of the sole
13 proprietorship is based solely on the findings of the audit of the corporation, we note that Ms. Gordon
14 failed to report substantial amounts of sales tax accrued that were recorded in her own records. Also,
15 for the first quarter 2002, petitioner transferred \$36,834 from the accrued sales tax account to an
16 income account. Since these facts relate directly to the period of operation by Ms. Gordon, we reject
17 petitioner's assertion that the finding of fraud for the sole proprietorship was based solely on
18 information applicable to the operation of the business by the corporation.

19 With respect to the assertion that, if the 10-year statute of limitations is applied, the NOD is
20 timely only for periods beginning October 1, 2001, petitioner relies on a January 21, 2005, letter to tax
21 professionals from Tax Policy Manager Jeffrey L. McGuire. The SD&R explains that petitioner has
22 misinterpreted the information presented in that letter. The letter explicitly states that the ten-year
23 statute of limitations applies to eligible tax reporting periods for which a notice of determination could
24 still be issued (without applying the 10-year statute of limitations) as of August 16, 2004 (the day the
25 amnesty legislation was enacted). In this case, if the 10-year statute of limitations had not been
26 enacted, an NOD for the period July 1, 2001, through September 30, 2001, would have been timely if
27 issued on or before October 31, 2004, which is after August 16, 2004. Accordingly, the first period
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1 subject to the 10-year statute of limitations is the third quarter 2001, and we find that the NOD was
2 timely under section 7073 for the period July 1, 2001, through December 31, 2002.

3 **Issue 2:** Whether further adjustments are warranted to the audited understatements of reported
4 taxable sales. We recommend no further adjustments.

5 Petitioners operated a restaurant, with sales of wine. The restaurant sold hot and cold food, for
6 consumption on and off the premises. The Department initiated an audit of the corporation, finding
7 that recorded sales tax reimbursement exceeded reported sales tax by \$63,116, which represented a
8 measure of unreported taxable sales of \$814,400. As explanation, petitioner stated that she applied a
9 ratio to total sales to establish the reported amount of taxable sales. However, she was unable to
10 explain how that ratio was computed or why she reported only a portion of recorded taxable sales. The
11 Department concluded that the understatement by the corporation was the result of fraud and decided
12 to audit the sole proprietorship also. For the sole proprietorship, the Department found that the amount
13 of sales tax reimbursement collected exceeded the amount of sales tax paid by \$70,690, which
14 represents a measure of unreported sales of \$904,397. Using profit and lost statements, the
15 Department computed achieved markups of 166 percent, overall, for the corporation, and 140 to 165
16 percent for the sole proprietorship. The Department considered those markups reasonable for this
17 restaurant and concluded that recorded total sales were substantially accurate. Upon examination of
18 cash register tapes and observation of the restaurant, the Department found that the corporation made
19 exempt sales of food products not sold in a form suitable for consumption in the restaurant. Based on a
20 discussion with Ms. Gordon, the Department estimated exempt food sales for both the corporation and
21 the sole proprietorship. To establish audited taxable sales, the Department reduced recorded total sales
22 by the audited amount of exempt food sales, recorded gift certificate sales, and an amount of interest
23 income recorded as a sale.

24 Ms. Gordon contends that, for a majority of the period during which she operated as a sole
25 proprietor, the business was more similar to a grocery store than a restaurant. On that basis, she asserts
26 that the majority of her sales were exempt sales of food products. As support, Ms. Gordon provided
27 pictures and newspaper articles to show that the business began as a grocery store rather than a
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1 restaurant. Also, petitioners contend that the audited amount of exempt food sales for the both audit
2 periods should be increased to reflect exempt sales of bakery goods.

3 Based on our review of the pictures Ms. Gordon provided, one of which showed a sign saying
4 “Market” above the doorway, along with menus that listed whole pies, we concluded in the D&R that
5 the business did operate as a grocery store during some portion of the audit period. Since we noted a
6 dramatic increase in sales tax accrued beginning in the second quarter 2000, we found that the nature
7 of the business changed to a restaurant during that period. As noted above, we recommended that the
8 liability be deleted from the determination for periods before April 1, 2000. Therefore, for all periods
9 relevant here, we find that both Ms. Gordon and the corporation operated the business as a restaurant.
10 Using information from the audit workpapers, we have computed that, for the first and third quarters of
11 2001 and 2002, the percentage of food sales to total sales averaged 90 percent, and the percentage of
12 taxable to total food sales averaged 81 percent. Since petitioners did not separately account for or
13 document its exempt sales of food products, all of the restaurant’s sales of food in a form suitable for
14 consumption on the premises were subject to tax. (Rev. & Tax. Code § 6359, subd. (d)(6)(A) and (B).)
15 With respect to the restaurant’s exempt sales of food products not sold in a form suitable for
16 consumption on the premises, the Department estimated, based on a discussion with Ms. Gordon, that
17 exempt food sales averaged \$100 per month in the early part of the audit period, increasing to \$400 per
18 month by the year 2001. We reviewed information in the audit workpapers that had been scheduled
19 from petitioners’ records and concluded that the audited amount of exempt food sales should be
20 increased to 3 percent of audited total sales. The Department has made those adjustments in the
21 reaudits dated April 29, 2009 (corporation), and April 30, 2009 (sole proprietorship). Petitioners have
22 provided insufficient evidence to support a greater increase in the audited amount of exempt food
23 sales, and we recommend no further adjustments.

24 **Issue 3:** Whether adjustments are warranted to the audited cost of self-consumed taxable
25 merchandise for the sole proprietorship. We recommend no adjustments.

26 The Department computed a cost of self-consumed taxable merchandise of \$458 per quarter,
27 which Ms. Gordon does not protest. She asserts that, since the NOD was not timely issued, the tax on
28 self-consumed merchandise cannot be assessed for the period she operated as a sole proprietor.

1 For the reasons addressed under Issue 1, we find that the NOD was timely issued for the period
2 beginning April 1, 2000, and we reject petitioner's argument that the tax on the cost of self-consumed
3 merchandise cannot be assessed because the NOD was not timely. Further, we find that the estimated
4 cost of self-consumed taxable merchandise appears reasonable, and Ms. Gordon has provided no
5 evidence to the contrary. Accordingly, recommend no adjustments.

6 **Issue 4:** Whether the understatements of reported taxable measure were the result of fraud or
7 intent to evade the tax. We conclude that the Department has established fraud by clear and
8 convincing evidence for the period April 1, 2000, through March 31, 2005.

9 As noted above, petitioners collected tax reimbursement from their customers and recorded the
10 sales as taxable in their records, and then, over the two audit periods, reported to the Board only about
11 one-third of those recorded taxable sales. In addition, the Department found that Ms. Gordon had
12 transferred funds from her accrued sales tax account to an income account. The Department concluded
13 the intentional transfer of funds was an act that required conscious thought and intent.

14 Petitioners dispute the fraud penalties on the basis that they hired inexperienced people to do
15 bookkeeping and prepare sales and use tax returns (SUTR's). Petitioners also assert that the software
16 they used to maintain records had defaults that created some of the reporting problems. Further, in a
17 post-conference memorandum, petitioners state that the gross receipts reported on the federal income
18 tax returns (FITR's) closely reconciled with total sales reported on SUTR's, and, for the years 2000,
19 2001, and 2002, the total sales reported on SUTR's exceeded gross receipts reported on FITR's.
20 Addressing the last argument first, we have calculated that the amounts of gross receipts on the FITR's
21 exceeded the amounts of total sales on the SUTR's by \$1,907,432 for the period 1997 through 2002
22 and by \$2,878,911 for 2003 and 2004. Thus, we find that petitioners' statement regarding the
23 similarity of amounts reported on FITR's and SUTR's is simply incorrect.

24 Ms. Gordon reported total sales of \$833,060 for the period April 1, 2000, through December
25 31, 2002, while recording total sales of \$2,303,168 for that period, meaning she reported about
26 36 percent of her *recorded* total sales. The corporation reported total sales of \$1,047,165 during the
27 period January 1, 2003, through December 31, 2005, while recording total sales of \$2,071,636 for that
28 period, meaning the corporation reported just over 50 percent of its *recorded* total sales. Between the

1 two of them for the period remaining at issue, they reported about 43 percent of their total recorded
2 sales. Similarly, petitioners reported far less sales tax than the amounts accrued in their records.
3 Ms. Gordon reported sales tax of \$37,018 for the period April 1, 2000, through December 31, 2002,
4 while accruing sales tax for that period of \$143,460, meaning she reported 26 percent of accrued sales
5 tax. The corporation reported sales tax of \$44,424 for the period January 1, 2003, through
6 December 31, 2005, while accruing sales tax for that period of \$107,540, meaning it reported
7 41 percent of its accrued sales tax. For the entire period, petitioners combined reported sales tax of
8 \$81,442 compared to their combined accrued sales tax of \$251,000, meaning they reported 32 percent
9 of their accrued sales tax. We find that the failure to report two-thirds of the sales tax reimbursement
10 collected from customers is clear and convincing evidence of fraud. We further find that the sole
11 proprietorship's transfer of \$36,864 from a sales tax accrual account to an income account was a
12 conscious act, demonstrating Ms. Gordon's knowledge that she was retaining amounts collected as
13 sales tax reimbursement rather than reporting such amounts as sales tax to the Board.

14 We are not convinced by petitioners' assertions that the understatements of reported sales tax
15 were the result of errors by inexperienced bookkeepers and flaws in accounting software. Petitioners
16 were responsible for verifying the accuracy of the records maintained by hired bookkeepers, whether
17 or not a software program was used. The discrepancies identified in both audits were of sufficient
18 magnitude that they should have been recognized by both Ms. Gordon and the corporation, even if
19 petitioners were not experienced in business and were not sophisticated users of computer software.
20 We do not accept that petitioners could have thought that the restaurant's sales were less than half of
21 the sales that their own records reflected. We do not accept that petitioners could have thought that
22 they owed sales tax equal to only 32 percent of the sales tax their own records reflected was due.
23 Petitioners have offered no plausible, non-fraudulent, explanation for the substantial discrepancies
24 between the amounts *recorded in their own records* and reported amounts. We find that petitioners
25 knowingly reported only a fraction of the recorded taxable sales. For all these reasons, we find that the
26 understatements of reported taxable sales for the periods April 1, 2000, through December 31, 2002,
27 and January 1, 2003, through March 31, 2005, were the result of fraud or intent to evade the tax, and
28 the fraud penalties were properly applied.

AMNESTY

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2 The entire period covered by the determination issued to Ms. Gordon was eligible for amnesty.
3 While Ms. Gordon applied for amnesty, she did not pay off the tax and interest or enter into a
4 qualifying installment plan by May 31, 2005. Accordingly, the penalties imposed by the amnesty
5 program are applicable. Since the NOD was issued to Ms. Gordon after the amnesty period, the
6 determination includes an amnesty double fraud penalty. (Rev. & Tax. Code § 7073, subd. (c).) An
7 amnesty interest penalty of \$19,156.97 will also be applied when the determination against Ms.
8 Gordon becomes final.

9 We explained in a letter to Ms. Gordon that she could request relief of the amnesty penalties in
10 accordance with Revenue and Taxation Code section 6592. Ms. Gordon responded by telephone,
11 stating that she did not intent to request relief of the amnesty penalties. Accordingly, we have no basis
12 to consider recommending relief of the amnesty penalties.

RESOLVED ISSUE

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14 In the D&R, we concluded that the Department has established fraud by clear and convincing
15 evidence for the period April 1, 2000, through March 31, 2005, but that there was insufficient evidence
16 to uphold the finding of fraud against Ms. Gordon for the period March 1, 1997, through March 31,
17 2000. Thus, the NOD was not timely for that period and we recommended that the liability for the
18 period prior to April 1, 2000, be deleted.

OTHER DEVELOPMENTS

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20 None.
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23 Summary prepared by Deborah A. Cumins, Business Taxes Specialist III
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EVIDENCE OF FRAUD RELIED ON BY DEPARTMENT

1.	Substantial deficiency, which cannot be explained as due to negligence or honest mistake.	Yes
2.	More than one set of records.	No
3.	Falsified records.	No
4.	Substantial discrepancies between recorded and reported amounts for which there is no valid explanation.	Yes
5.	Permit or license held by taxpayer for prior period indicating that taxpayer was knowledgeable about the requirements of law.	No
6.	Tax properly charged to customers, evidencing a knowledge of the requirements of the law, but not reported.	Yes
7.	Transfers of amounts of unpaid tax from the tax accrual account to another income account.	Yes
8.	Consistent substantial underreporting.	Yes