

CALIFORNIA STATE BOARD OF EQUALIZATION
APPEALS DIVISION SUMMARY FOR BOARD HEARING

In the Matter of the Administrative Protest)	
Under the Sales and Use Tax Law of:)	
)	
JOEL SANCHEZ,)	Account Number: SR Y KH 97-056442
dba J & S Produce)	Case ID 356200
)	
Taxpayer)	Stockton, San Joaquin County

Type of Business:	Floral shops with fruit sales
Audit Period:	4/4/97 – 3/31/04

<u>Items</u>	<u>Amount</u>
Understated sales per bank deposit analysis	\$470,860
Fraud penalty	\$ 19,804
Amnesty double fraud penalty	\$ 6,460
Finality penalty	\$ 7,922
Amnesty double finality penalty	\$ 2,584
Amnesty interest penalty	\$ 2,951

	<u>Tax</u>	<u>Penalties</u>
As disclosed by audit dated 2/6/06	\$164,877.92	\$41,219.52
Add amnesty double fraud penalty		6,460.01
Amounts reported on amnesty returns	- 85,661.00	-21,415.25
Penalties imposed on final liability		<u>+13,456.69</u>
As determined	\$ 79,216.92	\$39,720.97
Amount concurred in	<u>- 42,936.41</u>	
Protested	<u>\$ 36,280.51</u>	<u>\$39,720.97</u>
Tax liability	\$ 79,216.92	
Interest through 4/30/09	50,278.61	
Fraud penalty	19,804.27	
Amnesty double fraud penalty	6,460.01	
Finality penalty	7,921.69	
Amnesty double finality penalty	2,583.99	
Amnesty interest penalty	<u>2,951.01</u>	
Total tax, interest, and penalties	\$169,216.50	
Payments	<u>- 8,000.00</u>	
Balance due	<u>\$161,216.50</u>	

Monthly interest beginning 5/1/09	<u>\$474.78</u>
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UNRESOLVED ISSUES

Issue 1: Whether taxpayer has established that reductions to the understated taxable sales established using a bank deposit analysis is warranted. We find that taxpayer has failed to establish that reductions are warranted.

During the audit, the Department prepared a reconciliation of taxpayer's business bank deposits to calculate sales because taxpayer's books and records were inadequate for most periods at issue. Bank deposits were adjusted for items such as "wired in" deposits (for sales made by other florists for delivery by taxpayer, which are taxable to the other florists and not to taxpayer as explained in California Code of Regulations, title 18, section (Regulation) 1571), produce sales, and tax-included amounts. The Department also found that taxpayer's sales of produce were made during the first six months of the year. From records supporting produce sales that were made available for 2002 and 2003, the Department found that produce sales represent 42.24 percent of total sales made during the first six months of the two year test period. The Department applied the ratio to total bank deposits for the first six months of every year to establish nontaxable produce sales for each year.

Based on its analysis of taxpayer's business bank deposits for the audit period and allowing for nontaxable amounts, the Department determined that taxpayer had audited taxable sales of \$2,731,928, or unreported taxable sales of \$2,139,838 when compared to the reported taxable sales of \$592,090 for the audit period.

On appeal, taxpayer argues that the audited taxable sales of \$2,139,838 should be reduced by \$213,860 in additional fruit sales during the early part of his business because he did not start making sales of flowers (which are taxable) until July 1999. In support, taxpayer states that sales of flowers are almost always made by credit card and that he did not start accepting credit card payments until July 1999, as evidenced by his bank statements. Taxpayer also argues that the audited unreported taxable sales included \$257,000 which was from loans from family members. In support, taxpayer provided five undated promissory notes totaling \$257,000 (i.e., \$30,000, \$60,000, \$100,000, \$50,000, and \$17,000). However, at the appeals conference, taxpayer admitted that the promissory notes were drafted for purposes of this appeal and that they were not issued contemporaneously with the making of the loans. Taxpayer also indicated that the lender on each note was a family member or a distant

relative. Finally, taxpayer stated that the amounts set forth in the promissory notes were dispersed over a course of years and not in lump sum distributions as indicated in the notes; therefore, taxpayer stated that he could not tie a specific note to a specific deposit in his business bank account.

Taxpayer has not produced any evidence to support a finding that the audited taxable measure should be reduced by \$213,860 or some other amount. Moreover, we note that the Department has already provided taxpayer with an allowance of \$84,711 to provide a reasonable estimate of likely produce sales for periods prior to July 1999, even though taxpayer provided no documents to support such an allowance. Accordingly, we find that taxpayer has failed to show that reductions are warranted on this basis. Regarding the alleged loans, we are not able to verify that taxpayer received loans the proceeds of which were deposited into his bank account without adequate documentation, which taxpayer has not provided. Accordingly, we find that no reductions are warranted.

Issue 2: Whether the 25-percent penalty for fraud or intent to evade is supported by clear and convincing evidence. We conclude that it is.

On appeal, taxpayer asserts that the alleged large understatement in taxable measure does not prove that he acted fraudulently. Specifically, taxpayer states that he relied completely on his bookkeeper, Mr. Justo Lazo, to calculate his taxable sales and to file his returns correctly; however, taxpayer asserts that Mr. Lazo was negligent; taxpayer also claims that Mr. Lazo prepared taxpayer's returns from 2000 to 2004. Taxpayer also asserts that the Department's assertion that taxpayer "should have known" what was going on is not accurate, given that the floral shop was a fast growing business run by a person (taxpayer) who had limited knowledge of English and of California law.

Although fraud may not be presumed, it is rare to find direct evidence that fraud has occurred, and thus it is often necessary to make the determination based on circumstantial evidence. (*See Tenzer v. Superscope, Inc.* (1985) 39 Cal.3d 18, 30.) Circumstantial evidence indicative of fraud includes the understatement of income over a substantial period of time, inadequate records, a failure to file returns, implausible or inconsistent explanations of behavior, concealment of assets, and a failure to cooperate with tax authorities. (*See Bradford v. Commissioner of Internal Revenue* (9th Cir. 1986) 796 F.2d 303, 307-08.)

Here, taxpayer held an active seller's permit throughout the audit period, communicated easily

with us in English at the appeals conference, and admitted at the appeals conference that he collected sales tax reimbursement on his reported taxable sales, all of which support a finding that taxpayer had knowledge of the relevant aspects of the Sales and Use Tax Law.

Even though taxpayer had numerous people working for him at various locations, he operated his business as a sole proprietorship and was heavily involved with the business's day-to-day operations. Thus, taxpayer had knowledge of his business's actual taxable sales. In addition, the fact that taxpayer signed checks and managed the day-to-day business operations, such as payment of suppliers, etc., support a finding that taxpayer was reviewing his bank statements, which show a significant amount of deposits that cannot be accounted for on appeal. Based on the foregoing, we find that taxpayer's bank statements, combined with the fact that taxpayer was signing checks, was a sole proprietor, and was managing the day-to-day business operations, support a finding that taxpayer knew or was put on notice that not all of his taxable sales were being reported.

Additionally, the fact that taxpayer consistently underreported his taxable sales by an average of 361 percent throughout the entire audit period supports a finding that the taxpayer's actions were not the result of mere negligence or a single accounting error, but were the direct result of a specific intent to evade taxes.

Finally, we note that taxpayer has provided no proof that Mr. Lazo was negligent, that Mr. Lazo's alleged negligence was the cause of taxpayer's significant understatement in taxable sales, and that Mr. Lazo prepared taxpayer's returns from 2000 to 2004. Furthermore, in the alternative, taxpayer has not alleged that Mr. Lazo intentionally defrauded taxpayer by understating taxable sales. In addition, although taxpayer apparently had other bookkeepers working for him in 2003 (and possibly other years), taxpayer has not alleged or provided proof that any negligence or intentional misconduct of those bookkeepers contributed to taxpayer's significant understatement in taxable sales in 2003 (or any other year). Instead, the evidence shows that taxpayer significantly underreported his taxable sales throughout the audit period, and taxpayer has not shown that the significant understatement should be attributed to anyone other than himself.

Accordingly, based on the foregoing, we find that that the evidence clearly and convincingly establishes that taxpayer, with full knowledge of his obligations to pay tax on taxable sales,

intentionally engaged in repeated and substantial underreporting of the tax due. We therefore recommend that the fraud penalty be sustained. We note that, for the period commencing April 1, 2001, the NOD was timely without regard to whether there was fraud because the NOD was issued before the expiration of a waiver of limitations signed by taxpayer or within the usual three-year limitations period. However, if the fraud penalty is *not* sustained, the NOD would not have been issued timely for the first quarter 2001 and earlier, and the assessment of tax of \$25,862, measured by \$333,707, would be barred. We note that the ten-year limitations period under the amnesty program is not applicable to extend the limitations period for issuing an NOD for the first quarter 2001 and earlier. The amnesty ten-year limitations period applies to eligible tax reporting periods for which an NOD could have been issued as of August 16, 2004 (the date the amnesty legislation was enacted). The amnesty program did not serve to reopen a period that was closed on August 16, 2004. In the absence of fraud, an NOD for the first quarter 2001 had to be issued by April 30, 2004. So, in the absence of fraud, the first quarter 2001 and earlier was closed on August 16, 2004, which means the amnesty ten-year limitations period would be inapplicable for those periods.

Issue 3: Whether relief from the penalty for failing to timely pay the determination is warranted. We do not recommend relief.

Taxpayer filed amnesty returns with the Department on May 31, 2005, which was nine months before the Department issued a Report of Field Audit on February 6, 2006, and ten months before the Department issued its Notice of Determination (NOD) on March 30, 2006. The Report of Field Audit states on its face that taxpayer was given a credit for his prior amnesty payment and that taxpayer was being assessed a liability in excess of that amount; accordingly, the NOD was issued the following month for the amount still owed.

In his administrative protest dated June 1, 2006, taxpayer states that the reason for the late filing of his petition was that he did not realize the relevance of the NOD. Specifically, taxpayer states that he was confused and believed that the NOD was merely a summary of the amnesty returns that he filed 10 months before on May 31, 2005. Thus, taxpayer asserts that he did not respond or forward a

copy of the NOD to his CPA until after the 30-day deadline had expired.¹

The Report of Field Audit and the NOD clearly showed that taxpayer still owed tax, interest, and penalties of \$79,216.92, \$27,796.28, and \$26,464.28, respectively, in excess of the amounts he had previously paid. We do not believe that the Report of Field Audit and the NOD could have been any clearer, and taxpayer's failure to timely pay or petition the liability despite the clear notice of the additional liability is neither reasonable nor due to circumstances beyond his control. Accordingly, we conclude that relief is not warranted.

AMNESTY

Taxpayer timely applied for amnesty and filed amnesty tax returns on May 31, 2005; however, the measure of tax that taxpayer reported on his amnesty returns for the amnesty period (June 4, 1997 through December 31, 2002) was found to be understated by \$419,725, after the audit was completed, and thus, taxpayer was assessed tax on the understated taxable sales; including fraud and amnesty double fraud penalty for the amnesty eligible periods. When the liability became final, a finality penalty attached as well as a amnesty double finality penalty and amnesty interest penalty.

On July 8, 2008, taxpayer filed a request under penalty of perjury for relief of the amnesty penalties, stating that he made a good faith attempt to estimate the amount of the tax due on his amnesty returns and, therefore, the amnesty penalties should be relieved. In an email dated July 8, 2008, taxpayer's CPA, Mr. Peter Holtz, stated that if the Department had not denied taxpayer's loans from relatives, measuring \$257,000, and taxpayer's alleged nontaxable fruit sales, measuring \$213,860, the Department's determination of taxable measure for the amnesty period would have been reduced by \$470,860, which would have made taxpayer's estimate of the taxable measure reported on its amnesty returns for the amnesty period of June 4, 1997, through December 31, 2002, less than the Department's determination for the amnesty period.

Taxpayer did not produce adequate evidence to support reducing his liability incurred during

¹ Although the D&R treats taxpayer's declaration dated July 8, 2008, as requesting relief of the finality penalty, the declaration does not address the finality penalty or the circumstances surrounding taxpayer's failure to timely petition the determination or pay the determined liability. However, taxpayer's administrative protest does provide taxpayer's explanation, as noted above.

the amnesty period, nor do we believe that there is adequate evidence to show that taxpayer actually believed that the tax reported on amnesty returns would fully satisfy his deficiency in having reported and paid the correct tax when originally due during that period. Accordingly, we conclude that relief from the amnesty penalties is not warranted.

OTHER DEVELOPMENTS

None.

Summary prepared by Rey Obligacion, Business Taxes Specialist III

STATE BOARD OF EQUALIZATION
SALES AND USE TAX APPEAL

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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 throughout the audit period indicating that taxpayer was knowledgeable about the requirements of law.*	Yes
6.	Tax properly charged to customers, evidencing 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.	No
8.	Consistent substantial underreporting.	Yes

Operated the business as a sole proprietor with active management of business' day to day operations, signed checks, and significant amount of deposits that cannot be accounted for, support a finding that taxpayer knew or was put on notice that not all of his taxable sales were being reported.