Two New OTA Sales Tax Decisions – Part 1: Fraud, the 40 Percent Penalty, and Interest Relief[1]

by Philipp Behrendt

The California Office of Tax Appeals (OTA) recently published two precedential sales tax pending decisions that, in practical terms, answered questions regarding personal liability, penalties, and interest abatements for unpaid sales tax. Part I focuses on the *Appeal of Sundown Entertainment Group, Inc.*, 2026-OTA-225P. Here, the OTA sustained a large sales tax determination after the normal three-year statute of limitations had expired, holding that the CDTFA established fraud, properly imposed the 40 percent penalty for knowingly failing to remit collected sales tax reimbursement, and did not abuse its discretion in denying further interest abatement.

Part II will focus on *Appeal of Z. Sultana*, 2026-OTA-204P, where the OTA sustained personal liability against an individual under Revenue and Taxation Code Section 6829 for a corporation's unpaid sales tax.

Both cases are designated "Pending Precedential," meaning that the OTA has selected them for precedential treatment and, after the public-comment period, may become binding guidance in future OTA appeals unless the OTA ultimately declines to designate them as precedential. Their Pending Precedential status indicates that there are cases practitioners handling sales and use tax matters should pay close attention to.

And both cases involve a familiar but important principle: once a retailer collects sales tax reimbursement from customers, California takes the failure to remit that money seriously. The cases also show how the OTA evaluates the evidentiary record in sales tax disputes. Internal records, point-of-sale reports, sales worksheets, bank deposits, tax returns, and the taxpayer's own filings can be enough to sustain both the underlying liability and the penalties that follow.

Sundown: Fraud, the 40 Percent Penalty, and Interest Relief

Sundown involved a restaurant in Palm Springs operating as The Tropicale Restaurant & Lounge. CDTFA issued a Notice of Determination for $1,377,782 in tax, plus interest, and a 40 percent penalty of $551,112.80 for failing to remit collected sales tax reimbursement for the period January 1, 2011, through March 31, 2017.

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The facts were unfavorable to the taxpayer. CDTFA obtained monthly point-of-sale (POS) reports for each quarter of the liability period. Those POS reports summarized taxable sales and sales tax reimbursement collected. They also contained handwritten calculations or annotations showing that the taxpayer reported taxable sales were computed by reducing the recorded collected tax reimbursement by approximately 40 to 60 percent and then dividing the reduced amount by the applicable tax rate. The CDTFA determined that the POS system recorded $28,975,666 in taxable sales, but the taxpayer reported only $13,474,747, producing an understatement of $15,500,919 and an error ratio of 115 percent.

The Riverside County District Attorney filed a criminal complaint against the taxpayer's CEO, charging tax evasion and filing false or fraudulent returns. The charges were dismissed after a preliminary hearing when the magistrate found insufficient cause to believe the CEO was guilty. That dismissal, however, did not control the civil tax case.

The transcript of the oral hearing in the civil tax case shows why the case is particularly informative for practitioners. The taxpayer did not merely contest the amount of tax. It attacked the procedural foundation of the entire assessment. Counsel argued that the audit had effectively gone quiet when the matter was referred to the CDTFA's investigative side, that the later civil determination depended on records seized in the criminal case, and that the Superior Court's order allowing return or destruction of seized materials should prevent CDTFA from using those records in the OTA appeal. See Transcripts p. 7–14. The OTA rejected that argument at the threshold, admitting CDTFA's exhibits. In an OTA appeal, relevant evidence is generally admissible, subject to limited exceptions not present in the case, and CDTFA may base its determination on any information in its possession, citing *Appeal of Ajay Beri Corp.*, 2024-OTA-385P.

In *Ajay Beri*, the taxpayer operated multiple Subway franchises and maintained two sets of records: one set showing higher sales for franchisor reporting and another, lower set used for sales tax reporting. CDTFA's forensic review showed that sales tax amounts had been manipulated through formulas to reduce reported amounts. OTA held that the taxpayer's guilty plea, falsified records, interference with the audit, and custom formulas artificially deflating sales tax constituted direct and compelling evidence of fraud. OTA also admitted and relied on records connected to the criminal investigation, emphasizing that relevant evidence is generally admissible in the OTA proceedings.

For practitioners, that is one practical lesson of *Sundown*: in an OTA hearing, all relevant evidence is admissible, and the CDTFA may rely on any information in its possession even if the evidence would not be admissible in a criminal proceeding.

The first issue was the statute of limitations. Under Revenue and Taxation Code Section 6487(a), CDTFA generally must issue a deficiency determination within three years. But the three-year period does not apply "in the case of fraud, intent to evade this part or authorized rules and regulations, or failure to make a return." Because the Notice of Determination was issued after the ordinary three-year period had expired for all quarters, CDTFA had to establish fraud by clear and convincing evidence for each otherwise-barred period.

In finding that CDTFA had proven fraud, the OTA relied on discrepancies between reported sales and third-party records, on the taxpayer's POS reports, and handwritten calculations showing that someone acting for the taxpayer reviewed collected sales tax reimbursement and then deliberately calculated a lower amount to remit. The OTA treated those calculations as direct evidence that the taxpayer knowingly reported falsified information to avoid remitting tax reimbursement collected from customers.

Sundown argued that CDTFA could not rely on fraud to keep the statute of limitations open unless it imposed the 25 percent fraud penalty under Section 6485. Imposing only the 40 percent penalty under Section 6597 could not by itself keep the statute of limitations open. At the hearing Sundown's counsel argued that the fraud penalty was the "toll" CDTFA had to pay to cross the limitations bridge. See Transcripts p. 16-20, 27-30.

The OTA rejected that theory. It held that Section 6487(a) asks whether the case is one "of fraud" or "intent to evade," not whether CDTFA separately imposed the Section 6485 fraud penalty. Thus, CDTFA could establish fraud for limitations purposes while imposing the 40 percent penalty for a knowing failure to remit collected sales tax reimbursement. The opinion also noted CDTFA's Audit Manual position that, when the failure to remit collected tax reimbursement was due to fraud, CDTFA may forgo the fraud penalty and impose only the 40 percent penalty. OTA did not treat the Audit Manual as binding law, but it held that Section 6487 does not make imposition of the fraud penalty a prerequisite to the fraud exception.

Sundown also argued that the fraud issue was decided in the criminal proceeding and the doctrine of res judicata and collateral estoppel barred CDTFA from relitigating fraud. OTA rejected that argument as well, relying on a settled distinction between criminal proceedings and civil tax enforcement. Under *People v. Uhlemann*, 9 Cal. 3d 662 (1973), a magistrate's dismissal of criminal charges after a preliminary hearing does not decide guilt or innocence and does not bar further proceedings because the magistrate decides only whether sufficient or probable cause exists to hold the defendant for trial.

In *People v. Prewitt*, 52 Cal. 2d 330 (1959), the California Supreme Court held that dismissal of a prior criminal proceeding did not bar later prosecution on the same offense. The OTA also cited *Helvering v. Mitchell*, 303 U.S. 391 (1938), where the Supreme Court held that a

taxpayer's acquittal on a criminal tax-evasion charge did not bar the government from later asserting a civil fraud penalty. The Court reasoned that the acquittal established only that the government had not proved guilt beyond a reasonable doubt; it did not establish that fraud could not be proved under the lower civil standard.

Tax practitioners should note that a favorable outcome in a criminal case does not stop a taxing agency from successfully asserting additional tax and penalties for the years in issue in the criminal case.

In *Sundown*, the POS reports seized during the criminal investigation were devastating because they reflected both the amount of tax reimbursement collected and the taxpayer's method and actions for reducing the amount reported.

On the issue of fraud, the OTA cited *Appeal of Delgado*, 2018-OTA-200P, for the proposition that fraud is intentional wrongdoing with the specific intent to avoid a tax known to be due, and the CDTFA must prove fraud by clear and convincing evidence, including both direct and circumstantial evidence.

In *Sundown*, a number of facts were cited by the OTA for its finding of fraud. Since Sundown added a charge for sales tax reimbursement to its sales, Sundown "must have known it was required to remit the entirety of this amount to CDTFA." Sundown's POS reports showed omitted sales and contained handwritten notes indicating that prior to the quarterly sales tax deadline, someone, on behalf of Sundown, reviewed the POS reports and deliberately calculated and remitted sales tax that was between 40% and 60% less than the amount collected. This was "evidence showing that appellant knowingly reported falsified information to avoid remitting tax reimbursement, and this constitutes direct evidence of fraud." The OTA found that this showed intentional falsification, not mistake, bookkeeping confusion, or negligence. Further, the understatement was significant and consistent over multiple periods. Sundown "provided no explanation for the understatement."

The second issue—the measure of unreported collected sales tax reimbursement—followed from the same evidence. The CDTFA compared the collected sales tax reimbursement shown in the POS reports to the amounts reported on the sales and use tax returns. Because the CDTFA used the taxpayer's own records and a reconciliation method, which the OTA viewed as reasonable and rational, the burden shifted to the taxpayer to prove error. The taxpayer did not provide evidence showing a different measure. The OTA therefore sustained the $1,377,782 determination.

The third issue was the 40 percent penalty under Revenue and Taxation Code Section 6597. That penalty applies when a person knowingly collects sales tax reimbursement and fails to timely remit if the unremitted amount exceeds statutory thresholds. The OTA sustained the

penalty because the same evidence that proved fraud also showed knowing collection and non-remittance. The POS reports reflected the amount of sales tax reimbursement collected, and the handwritten calculations showed that the taxpayer remitted only a reduced amount. The OTA found that the unremitted amount exceeded the statutory threshold and that the taxpayer did not establish grounds for relief.

Finally, the OTA addressed Sundown's claim that it was entitled to additional interest abatement. Revenue and Taxation Code Section 6593.5 allows the CDTFA, in its discretion, to relieve interest where the failure to pay tax is due in whole or in part to an unreasonable error or delay by a CDTFA employee acting in an official capacity. The OTA reviews the CDTFA's denial of interest relief for abuse of discretion. The taxpayer argued that the CDTFA unreasonably delayed the civil determination while pursuing what the taxpayer characterized as meritless criminal charges. The CDTFA had already conceded five months of interest relief but denied further relief. The OTA sustained the denial. The decision to prosecute was made by the Riverside District Attorney, not the CDTFA, and the pendency of a criminal proceeding did not constitute unreasonable CDTFA error or delay. The OTA also observed that the results of a criminal investigation may be relevant to a related civil tax proceeding.

Practitioner Takeaways

The decision reinforces several practical points for California sales tax controversies.

First, fraud can keep otherwise closed sales tax periods open even when CDTFA does not impose a fraud penalty. *Sundown Entertainment* makes clear that the fraud exception in Section 6487(a) is independent of the 25% fraud penalty in Section 6485. CDTFA may prove fraud for limitations purposes and still choose another penalty regime, including the 40 percent penalty under Section 6597.

Second, a criminal dismissal is not necessarily a civil tax victory. Under *Uhlemann*, *Prewitt*, and *Mitchell*, criminal proceedings and civil tax proceedings serve different functions, apply different burdens of proof, and a government loss in a related criminal case does not have a preclusive effect on a civil tax case. A preliminary hearing dismissal does not decide civil fraud, and even a criminal acquittal does not necessarily bar a later civil fraud determination.

Third, evidentiary objections must be tailored to the OTA forum. *Sundown* shows that records connected to a criminal investigation may still be admitted and relied upon in a civil OTA proceeding if they are relevant. Practitioners should not assume that defects or limitations in a criminal case will automatically exclude the same documents from the OTA record.

Finally, interest abatement remains narrow. Delay must be attributable to unreasonable error or delay by CDTFA employees. The mere fact that the CDTFA waited for a criminal matter to develop or resolve will not necessarily support interest relief, especially where the criminal matter was handled by a district attorney and the criminal investigation was relevant to the civil case.

Philipp Behrendt *is a Principal at Hochman Salkin Toscher Perez P.C., licensed in California as well as in Germany and assists in advising clients in civil and criminal tax controversies as well as international money laundering investigations stemming from tax avoidance structures. He also focuses on the technical aspects involved in advising voluntary disclosures in connection with DeFis, NFTs, and other crypto assets. Philipp is a Liaison to the Young Lawyer Committee for the ABA Tax Section's Civil and Criminal Tax Penalties Committee and served on the Beverly Hills Bar Association's Barristers Board of Governors from 2022 to 2023. Philipp is the Chair of the Beverly Hills Bar Association's Tax Section and the Blockchain and Web3 Law Section.*

For more information, please contact Philipp Behrendt at behrendt@taxlitigator.com