OFFICE OF TAX APPEALS

STATE OF CALIFORNIAm

In the Matter of the Appeal of:	) OTA Case No. 18043020
	) CDTFA Account No. 102-049629
TMHR COLLECTIVE CORPORATION	) CDTFA Case ID 857430
	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Elizabeth Sheldon, Attorney David Lutz, Accountant
For Respondent:	Randy Suazo, Hearing Representative Christopher Brooks, Tax Counsel IV Jason Parker, Chief of Headquarters Operations
For Office of Tax Appeals:	Richard A. Zellmer, Business Taxes Specialist III

K. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, TMHR Collective Corporation (appellant) appeals a decision issued by respondent, California Department of Tax and Fee Administration (CDTFA)[1] denying appellant's petition for redetermination of the Notice of Determination (NOD) for a tax liability of $460,083.96, plus accrued interest, and a negligence penalty of $46,008.53 for the period October 1, 2011, through September 30, 2014 (audit period).

In its subsequent Decision and Recommendation (D&R), CDTFA reduced the understated measure of tax from $5,141,145 to $4,976,145, which will result in reductions to the tax and penalty, and denied the remainder of the petitioned amount.

Office of Tax Appeals (OTA) Administrative Law Judges Keith T. Long, Andrew J. Kwee, and Andrew Wong held an oral hearing for this matter in Cerritos, California, on

[1] Sales taxes were formerly administered by the State Board of Equalization (BOE). In 2017, functions of the BOE relevant to this case were transferred to CDTFA. (Gov. Code, § 15570.22.) For ease of reference, when referring to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to the BOE; and when referring to acts or events that occurred on or after July 1, 2017, "CDTFA" shall refer to CDTFA.

June 17, 2020.[2] At the conclusion of the hearing, the record was closed and this matter was submitted for decision.

ISSUES

1. Whether any additional reduction to the measure of unreported taxable sales is warranted.
2. Whether appellant was negligent.

FACTUAL FINDINGS

1. Appellant operated a medical marijuana dispensary beginning in 2011. Appellant operated from 10 a.m. to 8 p.m., seven days per week. CDTFA closed appellant's seller's permit effective December 31, 2014. During the audit period, appellant reported total sales of $345,269, claimed nontaxable sales of $26,414, and taxable sales of $318,855.
2. CDTFA audited appellant for the period October 1, 2011, through September 30, 2014. For the audit, appellant provided its federal income tax returns for the years of 2010, 2011, 2012, and 2013. Appellant did not provide any other books and records for audit, such as cash register tapes, sales invoices, sales journals, merchandise purchase invoices, merchandise purchase journals, profit and loss statements, and sales tax worksheets.
3. CDTFA found no material differences between the amounts that appellant reported on its federal income tax returns for 2012 and 2013 and the amounts that appellant reported on its sales and use tax returns covering that period. CDTFA then scheduled appellant's reported taxable sales on a quarterly basis and divided that amount by the number of days in each quarter (91) and a sales price of $50 per sale and found that appellant's reported taxable sales were the equivalent of reporting 6 customers per day or .58 customers per hour.
4. CDTFA performed an outdoor observation of the business for a total of five hours on four different days. The observation tests each occurred between 10 a.m. and 2:50 p.m. Each person that entered the business was counted as a purchaser. The observations occurred as follows:

[2] The oral hearing was noticed for Cerritos, California, and conducted electronically due to COVID-19.

- On October 2, 2014, CDTFA observed 16 purchasers enter the business during a one-hour period from 1:50 to 2:50 p.m.[3]
- On October 7, 2014, CDTFA observed nine purchasers entering the business during a one-hour period from 11:00 a.m. to 12:00 p.m.
- On October 28, 2014, CDTFA observed six purchasers entering the business during a one-hour period from 1:30 p.m. to 2:30 p.m.
- On November 7, 2014, CDTFA observed 19 purchasers entering the business during a two-hour period from 10:00 a.m. to 12:00 p.m. CDTFA attempted to perform additional observations on this day but found the business closed.[4]

5. In total, CDTFA observed 50 customers enter the business during a total of 5 hours. CDTFA calculated an average of 10 sales per hour (50 customers ÷ 5 hours).
6. CDTFA did not have information regarding the amounts of each purchase made at appellant's business. Thus, based on its experience in auditing other medical marijuana dispensaries in appellant's area, CDTFA estimated that appellant's customers purchased an average of $50 of merchandise at each visit. Based on this information, CDTFA calculated average taxable sales of $500 per hour ($50 x 10 customers per hour).
7. CDTFA multiplied the audited average hourly sales of $500 by the number of hours that the business was open each day (10 hours) to calculate audited weekly sales of $35,000 ($500 per hour x 10 hours per day x 7 days). CDTFA multiplied appellant's weekly sales by the number of weeks in each quarter to find audited taxable sales of $455,000 per quarter ($35,000 x 13 weeks) and $5,460,000 for the audit period ($455,000 x 12 quarters). CDTFA compared appellant's audited taxable sales for the audit period to its reported taxable and found unreported taxable sales of $5,141,145 for the audit period. CDTFA also concluded that appellant was negligent.
8. Respondent issued an NOD to appellant on January 12, 2015, based on the aforementioned audit, in the amount of $460,083.96 tax, plus accrued interest, and a

[3] According to CDTFA's audit workpapers five purchasers entered the business at the same time (2:18 p.m.) during this observation.

[4] Appellant argues that it terminated operations on November 7, 2014. In CDTFA's audit workpapers, CDTFA notes that it found the business closed on this day and that it would not perform any additional observations as a result. Nevertheless, the audit workpapers indicate that the business's termination date is unknown. At the appeals hearing, CDTFA continued to assert that it did not know when the business closed.

negligence penalty of $46,008.53. Appellant filed a timely petition for redetermination protesting the NOD in its entirety. On April 7, 2016, CDTFA issued a D&R finding that the number of days the business was open during the audit period should be reduced by 11 days per year to account for holidays. CDTFA also found that it was necessary to correct a clerical error in its calculation of the taxable measure. CDTFA calculated that making these two adjustments would reduce the unreported taxable sales from $5,171,904 to $4,976,145. CDTFA otherwise denied the petition for redetermination.

9. Appellant filed the instant appeal with OTA.

DISCUSSION

Issue 1: Whether any additional reduction to the measure of unreported taxable sales is warranted.

California imposes a sales tax on a retailer's retail sales in this state of tangible personal property, measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, § 6051.) All of a retailer's gross receipts are presumed subject to tax, unless the retailer can prove otherwise. (R&TC, § 6091.) It is the retailer's responsibility to maintain complete and accurate records and to make them available for examination.

When CDTFA is not satisfied with the amount of tax reported by the taxpayer, CDTFA may determine the amount required to be paid on the basis of any information which is in its possession or may come into its possession. (R&TC, §§ 6481, 6511.) In the case of an appeal, CDTFA has a minimal, initial burden of showing that its determination was reasonable and rational. (See *Schuman Aviation Co. Ltd. v. U.S.* (D. Hawaii 2011) 816 F.Supp.2d 941, 950; *Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Myers* (2001-SBE-001) 2001 WL 37126924.) Once CDTFA has met its initial burden, the burden of proof shifts to the taxpayer to establish that a result differing from CDTFA's determination is warranted. (*Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 616.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (See *ibid.*; see also *Appeal of Magidow* (82-SBE-274) 1982 WL 11930.)

Here, appellant did not provide a complete set of books and records for the audit. In fact, during the audit, appellant stated that its books and records were unavailable and in the Internal

Revenue Service's (IRS) possession.[5] Despite this assertion, appellant continued to operate and did not provide any books or records for periods after the date that appellant turned its books over to the IRS. Similarly, appellant asserted that the Los Angeles police department seized and destroyed its records. However, appellant continued to operate after the Los Angeles police department's alleged seizure and did not provide any records for that period. Instead, appellant only provided federal income tax returns.[6] We note that CDTFA did not find any material differences between appellant's sales and use tax returns and appellant's federal income tax returns for this period. Nevertheless, CDTFA found that appellant's reported taxable sales were the equivalent of six sales per day. This is evidence that appellant did not report all of its taxable sales.

On appeal, appellant provided statements of activity, which purport to show appellant's taxable sales during the period 2008 through 2013. At the hearing, appellant asserted that the statements of activity were created during the audit period. However, appellant did not provide any documentation to support the amounts recorded in its statements of activity. Additionally, appellant did not provide a statement of activity for the year 2014. Appellant also recorded zero taxable sales on its statement of activity for 2011, despite reporting taxable sales of $24,008 on its sales and use tax return for the fourth quarter of 2011. Thus, appellant's statements of activity cannot be relied on because they are incomplete, unsupported by the evidence, and in conflict with other information that appellant provided.

CDTFA calculated the taxable measure based on an outdoor observation test. In the absence of adequate records, we find that CDTFA was justified in using an alternative method to establish audited taxable sales.

Next, we consider whether CDTFA has met its minimal burden of showing that its determination was reasonable and rational. As explained above, CDTFA performed four observations of the business for a total of five hours. In other words, CDTFA projected

[5] CDTFA provided evidence that the IRS required appellant to provide books and records for the period September 2006, through March 31, 2007. There is no evidence that the IRS obtained any of appellant's books or records for the audit period.

[6] The federal income tax returns are not a part of the record. CDTFA contends that appellant reported $0 in gross receipts on its 2010 and 2011 federal income tax returns; however, CDTFA only transcribed information from appellant's 2012 and 2013 returns in its audit workpapers.

unreported taxable sales for the three-year audit period based on one-half of one day's observation.

When asked about the timing of each observation, CDTFA asserted that scheduling issues would prevent the auditor from observing the business after 5:00 p.m. We find this explanation to be without substance. Specifically, according to CDTFA's own Audit Manual, which is cited in the D&R, observation tests are generally performed for full days and on weekends.[7] As such, it appears that auditors are required, by CDTFA policy, to perform observations outside of a typical 9:00 a.m. to 5:00 p.m. workday.[8] Even if this is not the case, CDTFA did not perform any observations between the hours of 3:00 p.m. and 5:00 p.m., which were apparently within the auditor's work schedule.

It is also worth noting that during CDTFA's own appeals process, CDTFA found the observation test to be insufficient. Indeed, CDTFA states that it "did not adhere" to its own policies because the observation tests were not conducted for full days and because no alternate method was employed to support the reasonableness of audited sales. The D&R also cites an internal memorandum dated October 28, 2015, which requires three full days of observation. However, the October 28, 2015 memorandum was issued after CDTFA completed appellant's audit and there is no evidence that the memorandum's requirements applied retroactively. CDTFA also attempted to carry out further observations on November 7, 2014, and found the business closed. Consequently, CDTFA was unable to increase the number of observation tests because appellant stopped doing business. Because CDTFA could not actually perform any more observations, we find that the four observation tests are the best and only available evidence. Therefore, CDTFA's use of the four observation tests to calculate the taxable measure is reasonable and rational.

Similarly, CDTFA was unable to calculate appellant's average sales price because appellant did not provide any books or records other than its federal income tax returns. Instead, CDTFA used the average purchase price ($50) obtained from the audit of a similar business in

[7] CDTFA explained that the Audit Manual provision that it cited in the D&R applies only to bars and restaurants. Nevertheless, it is indicative of the fact that auditors perform observation tests outside of a 9:00 a.m. to 5:00 p.m. workday.

[8] CDTFA's Audit Manual summarizes CDTFA's audit policies and procedures and has no precedential value in an appeal before OTA. As such, we do not further address appellant's contention that the audited liability is invalid on the basis that CDTFA failed to follow its own Audit Manual.

the area. Since appellant did not provide any documentation from which CDTFA could calculate appellant's sales, we find that it was reasonable for CDTFA to use its knowledge and experience of auditing similar businesses to determine appellant's audited average sales price.

As to the average audited number of sales per hour, CDTFA counted each person entering the business as a purchaser. There is nothing in the record to show that CDTFA made any effort to determine whether a person entering the business actually made a purchase. For example, CDTFA could have counted people carrying white bags as they left the business as purchasers.[9] There is also nothing in the record to show that CDTFA attempted to determine which individuals made a purchase when they entered the business as part of a group. For example, according to CDTFA's October 2, 2014 observation test notes, five people entered the business at 2:18 p.m. Each of these people were counted as individual customers. Similarly, CDTFA recorded groups of two and three entering the business at the same time in each of its observations and recorded each person as a purchaser.

By contrast, appellant provided a police report documenting police interviews and observations of appellant's customers. The police report indicates that not every person made a purchase and lists a variety of reasons including the following: appellant's poor customer service and the customer's failure to provide a medical marijuana recommendation. The police report also concluded that the business began requiring a medical marijuana recommendation on September 3, 2013.

At the appeals hearing, CDTFA argued, for the first time, that it was justified in counting every person that entered the business as a purchaser because of the low price per sale used during the audit ($50 per sale). CDTFA argued that in 2015, the average dispensary sales price per customer was $70 in California.[10] CDTFA asserted that, when compared to the $70 sales price, the $50 sales price was the equivalent of reducing appellant's sales by three out of every ten people entering the business. This attempt to retroactively account for people entering the business that did not make a purchase is without basis. As discussed above, CDTFA used the $50 average sales price based on its experience and knowledge of dispensaries in the same area as appellant. Therefore, it appears that the average sales price in appellant's area was less than

[9] On appeal, appellant provided a police report which states that police officers observed people leaving the business carrying white paper bags.

[10] CDTFA cites a survey allegedly available online at: <website www.mjbizdaily.com>. CDTFA did not attempt to introduce the survey or any information from the website as evidence in this appeal.

the average sales price in this state. It is unreasonable to assert that the audited average sales price of $50 accounts for people entering the business that did not make a purchase when CDTFA knows that the average sales price in the area is less than the average sales price in the state.

We reject CDTFA's assumption that every person that entered the business made a purchase. Indeed, the available evidence shows that appellant failed to make sales for a number of reasons. Therefore, appellant's audited average hourly sales must be reduced. To accomplish this reduction, we use the best available evidence: CDTFA's observation test notes.[11] We reduce the audited sales in each observation period where more than one person entered the business in the same minute. The number of purchasers observed on October 2, 2014, is reduced from 16 to 11; the number of purchasers observed on October 7, 2014, is reduced from 9 to 8; and the number of purchasers observed on November 7, 2014, is reduced from 19 to 16.[12] This results in a reduction of the average number of sales per hour from 10 per hour to 8 per hour. We calculate that this will reduce appellant's unreported taxable sales from $4,976,145 to $3,884,145.

Issue 2: Whether appellant was negligent.

CDTFA imposed the negligence penalty provided by R&TC section 6484 because it concluded appellant was negligent. On appeal, appellant has not made any specific argument regarding the negligence penalty. Instead, appellant asserts that the negligence penalty generally should not apply because the audit liability is incorrect.

A taxpayer is required to maintain and make available for examination on request by CDTFA all records necessary to verify the accuracy of any return filed, or, if no return has been filed, to ascertain and determine the amount required to be paid. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698 (b)(1).) Such records include, but are not limited to: (1) the normal books of account ordinarily maintained by the average prudent businessperson engaged in the

[11] The police report also documents customers that did not make a purchase. The police report indicates that the police spoke with four people, two of whom did not make a purchase. Considering the small sample size, we do not believe that a 50-percent sales rate is representative of the business. This is especially unlikely given the fact that one of the two non-purchasers indicated that he was turned away for lack of a medical recommendation for the first time and was a long-time customer. As such, we use the only other available data (i.e., CDTFA's observation test notes) to reduce appellant's average number of sales per hour.

[12] The number of purchasers observed on October 28, 2014, is unchanged.

activity in question; (2) bills, receipts, invoices, cash register tapes, or other documents of original entry; and (3) schedules of working papers used in connection with the preparation of the tax returns. (Cal. Code Regs., tit. 18, § 1698 (b)(1).) Failure to maintain and provide complete and accurate records will be considered evidence of negligence. (Cal. Code Regs., tit. 18, § 1698 (k).)

Here, appellant had not been previously audited. CDTFA calculated unreported taxable sales of $4,976,145, which when compared to appellant's reported taxable sales represents an error ratio of 1,560 percent. Such a large reporting error is evidence of negligence.

Regarding appellant's lack of books and records, at the time of the audit, appellant claimed that its books and records for the audit period were in the possession of the IRS, and thereafter that they were seized by the Los Angeles police department. According to an IRS summons, appellant was only required to provide books and records for the period January 1, 2006, through March 31, 2007, which is well before the audit period. There is no evidence that appellant was required to provide any information to the IRS for periods after March 31, 2007. There is also no evidence that appellant's books and records were destroyed by a police department.

Finally, we note that appellant continued to operate after the alleged seizure of books and records, as evidenced by the observation tests performed by CDTFA. Despite this fact, appellant did not provide any books or records from which its taxable sales could be verified. Appellant's books and records, particularly the source documents, such as cash register tapes and sales invoices, could have been useful in determining appellant's sales. We find that the failure to provide books and records for audit is additional evidence of negligence.

During the audit period, appellant reported taxable sales of $318,855. When compared to the number of hours that the business was open each day (10 hours) and the average audited sales price ($50), appellant's reported taxable sales are equivalent to just six sales per day. Given the number of customers that CDTFA observed entering appellant's business (10 per hour), appellant must have known that the reported taxable sales were grossly understated. Thus, persuasive evidence exists that establishes that appellant possessed actual knowledge such that any bookkeeping and reporting errors cannot be attributed to appellant's bona fide and reasonable belief that appellant's bookkeeping and reporting practices were sufficiently compliant with the requirements of the sales and use tax law. (*Independent Iron Works, Inc. v.*

State Bd. of Equalization (1959) 167 Cal.App.2d 318,321-324.) Accordingly, we find that appellant was negligent.

HOLDINGS

1. Reduce the measure of unreported taxable sales from $4,976,145 to $3,884,145 pursuant to our instructions in issue 1. Otherwise CDTFA's action is sustained.
2. Appellant was negligent.

DISPOSITION

Reduce the measure of unreported taxable sales to $3,884,145. Adjust the corresponding negligence penalty. CDTFA's action otherwise denying the petition, is sustained.

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Keith T. Long
Administrative Law Judge

We concur:

DocuSigned by:
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Andrew J. Kwee
Administrative Law Judge

DocuSigned by:
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Andrew Wong
Administrative Law Judge

Date Issued: 7/22/2020