OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 19075063
	) CDTFA Case ID 247-070
KHUSHI INVESTMENTS, LLC	)
DBA SMOKE SHOP	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Snehal Soni, Managing Member Jitesh Kothari, Enrolled Agent
For Respondent:	Randy Suazo, Hearing Representative Christopher Brooks, Tax Counsel IV Jason Parker, Chief of Headquarters Ops.
For Office of Tax Appeals:	Lisa Burke, Business Taxes Specialist III

A. WONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Khushi Investments, LLC (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA) denying appellant's petition for redetermination of a Notice of Determination (NOD) issued on April 27, 2017, for a tax liability of $134,877.05, plus accrued interest, for the period April 1, 2013, through March 31, 2016 (audit period).[1]

Office of Tax Appeals (OTA) Administrative Law Judges Andrew Wong, Daniel K. Cho, and Nguyen Dang held an oral hearing for this matter on November 17, 2020.[2] At the conclusion of the oral hearing, the record remained open to allow appellant time to submit a

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

[2] Although the oral hearing was noticed for Cerritos, California, we conducted the oral hearing by videoconference with the parties' consent due to the coronavirus/COVID-19 pandemic.

written summary of its oral presentation and to provide CDTFA with an opportunity to respond. On February 1, 2021, we closed the record and this matter was submitted for decision.

ISSUE

Whether a reduction to the amount of unreported taxable sales is warranted.

FACTUAL FINDINGS

1. Appellant operated three smoke shops: one closed effective June 30, 2015, during the audit period; two operated throughout the audit period.[3] At these smoke shops, appellant sold tobacco products, vapes, water pipes, soda, Gatorade, water, and miscellaneous taxable merchandise. Appellant also sold lottery tickets and Scratchers at one of the smoke shops that operated throughout the audit period.
2. For the audit period, appellant reported total sales of $1,149,236, and claimed deductions of $164,967 for exempt sales of food products, which resulted in reported taxable sales of $984,269.
3. CDTFA first contacted appellant and appellant's representative regarding the audit on May 12, 2016. According to CDTFA's BOE-414Z (*Assignment Activity History*) form (BOE-414Z), through November 10, 2016, both parties exchanged emails regarding books and records (submitted and missing), information schedules, and questions and clarifications. This was appellant's first audit.
4. For audit, appellant provided the following records: federal income tax returns for 2013 and 2014; bank statements and merchant statements for the audit period; merchandise purchase invoices for the first quarter of 2016 (1Q16); and, from its remaining two smoke shops, cash register Z-tapes for June 2016 (which was outside of the audit period).[4]
5. CDTFA attempted to use several audit methods to verify the accuracy of appellant's reported taxable sales.
6. Initially, CDTFA considered performing a bank deposits analysis to establish audited total sales.[5] However, based on bank statements, CDTFA found that most of appellant's

[3] These two remaining smoke shops closed effective March 31, 2017, after the audit period.

[4] Cash register Z-tapes are the part of the cash register tapes that summarizes the sales by category for a given period of time.

[5] The bank deposits audit method is described in CDTFA's Audit Manual section 0405.25.

bank deposits were credit card deposits and determined that appellant did not deposit cash regularly. Based on the available records, CDTFA could not establish appellant's cash sales and concluded that it could not perform an accurate bank deposits analysis.

7. Next, CDTFA considered performing a markup analysis.[6] After it found that appellant's merchandise purchase invoices for 1Q16 were incomplete,[7] CDTFA requested purchase data from appellant's primary vendors. CDTFA received responses from three vendors, which showed that appellant made more purchases than were recorded in the 1Q16 merchandise purchase invoices. Additionally, during the observation tests described below, CDTFA found that appellant sold items (incense, weight scales, and smoking pipes) that were not recorded in either appellant's merchandise purchase invoices for 1Q16 or information from vendors. Lacking complete merchandise purchase information, CDTFA determined that it could not perform an accurate markup analysis.

8. Subsequently, CDTFA decided to analyze reported sales using a credit card projection method.[8] For its credit card projection method, CDTFA employed an observation test. Before the observations began, the parties completed a BOE-805 (*Observation Test Fact Sheet*) form (BOE-805), which documented information about appellant's business operations, including busy/slow months, busy/slow days of the week, and busy/slow hours. For busy/slow months, appellant indicated "N/A." Appellant's representative signed the form on November 18, 2016.

9. CDTFA observed appellant's operations on the following three days: (1) Saturday, November 19, 2016; (2) Monday, November 21, 2016; and (3) Tuesday, November 22, 2016. Afterwards, appellant claimed that both smoke shops' sales were unusually high on the observed days due to the then-upcoming Thanksgiving holiday. Accordingly, both parties agreed to additional testing for the week of December 12, 2016.

10. Before further observations began, the parties updated the BOE-805 to document the reason for, and the parties' agreement to, additional testing. Appellant did not update

[6] The markup method is described in CDTFA's Audit Manual section 0407.10.

[7] Appellant's 1Q16 merchandise purchase invoices showed that 4.41 percent of appellant's merchandise purchases were of nontaxable merchandise, but all those purchases were for only one of the two smoke shops. The merchandise purchase invoices for the second smoke shop did not include any nontaxable merchandise.

[8] The credit card projection method is described in CDTFA's Audit Manual section 0810.12.

information regarding its busy/slow months. Appellant signed the form on December 9, 2016. Subsequently, CDTFA observed appellant's operations on the following two days: (1) Thursday, December 15, 2016; and (2) Friday, December 16, 2016.

11. For the five days of observation, CDTFA compiled total sales of $3,446, excluding sales of lottery tickets and Scratchers, for both smoke shops. Sales paid by credit card totaled $745, which represented a credit-card-to-total-sales ratio of 21.62 percent ($745 ÷ $3,446). Using appellant's bank statements for the audit period, CDTFA compiled credit card deposits of $548,470. CDTFA then divided audited credit card sales of $548,470 by the credit card sales ratio of 21.62 percent to establish audited taxable sales of $2,536,864, which exceeded appellant's reported taxable sales for the audit period by $1,552,597 (rounded).[9]

12. To test whether the results of the credit card projection method were reasonable, CDTFA considered computing taxable sales for the audit period based on the average daily taxable sales shown in appellant's cash register Z-tapes for June 2016. However, because average daily taxable sales of $748 shown in the cash register Z-tapes was substantially lower than average daily taxable sales of $1,304 from CDTFA's observation tests, CDTFA determined that the cash register Z-tapes did not accurately reflect appellant's sales and concluded that the credit card projection method already utilized the best available evidence of appellant's sales.

13. On April 27, 2017, CDTFA issued to appellant an NOD based on unreported taxable sales of $1,552,597. CDTFA did not recommend imposing a negligence or fraud/evasion penalty because it found no evidence of negligence or intent to evade tax on appellant's part.

14. Appellant timely filed a petition for redetermination, which CDTFA denied on June 21, 2019. This appeal followed.

[9] In establishing audited taxable sales, CDTFA made no allowance for exempt sales of Gatorade and water. CDTFA observed no sales of Gatorade or water during its five days of observation, so CDTFA determined that any exempt sales were immaterial.

DISCUSSION

California imposes upon a retailer a sales tax measured by the retailer's gross receipts from the retail sales of tangible personal property in this state, 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.)

If CDTFA is not satisfied with the accuracy of the sales and use tax returns filed, it may base its determination of the tax due upon the facts contained in the returns or upon any information that comes within its possession. (R&TC, § 6481.) It is the retailer's responsibility to maintain and make available for examination on request all records necessary to determine the correct tax liability, including bills, receipts, invoices, or other documents of original entry supporting the entries in the books of account. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).)

In the case of an appeal, CDTFA has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Talavera*, 2020-OTA-022P.) 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. (*Ibid*.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid*.) To satisfy the burden of proof, a taxpayer must prove both of the following: (1) the tax assessment is incorrect, and (2) the proper amount of the tax. (*Appeal of AMG Care Collective*, 2020-OTA-173P.)

Here, the only source documents provided by appellant to support its reported taxable sales were incomplete cash register Z-tapes for June 2016, a one-month period after the audit period. Appellant did not otherwise provide cash register receipts, sales journals, or daily sales summary worksheets from the audit period. We find that the books and records provided for examination were not sufficient to verify the accuracy of appellant's reported taxable sales using a direct audit approach such as a bank deposits analysis, so CDTFA was justified in using an indirect audit approach to establish audited taxable sales. After finding that complete merchandise purchase information was not available, CDTFA concluded that a reliable markup analysis would not be feasible. Because reliable information about appellant's credit card deposits was available for the audit period (in the guise of bank statements), CDTFA determined that a credit card projection method, coupled with observation tests, represented the most effective approach for analyzing reported taxable sales and establishing audited taxable sales.

The credit card projection method and observation tests are established audit methods. We have examined CDTFA's analysis based on the credit card projection method and have found no errors in the procedures or in the computations. Therefore, the burden shifts to appellant to establish by documentation or other evidence that a reduction to the amount of audited taxable sales is warranted.

On appeal, appellant makes four arguments. We address each below.

Appellant's First Argument: Audit Result Is Skewed

Appellant was notified of the audit in May 2016, but argues that CDTFA deliberately delayed the audit, specifically the observation tests, until the busy holiday season, when CDTFA could observe higher daily sales volume. Appellant contends that CDTFA then projected the above-average daily holiday-season sales volume over the three-year audit period, thereby artificially inflating appellant's audited unreported taxable sales. Appellant alleges that CDTFA's delaying tactics entailed requesting a revolving set of documents each time appellant inquired about the audit's status.

This argument appears to misconstrue the role observation tests played in CDTFA's credit card projection method. CDTFA did not use the observation tests to establish the average amount of daily sales to be projected, but rather to establish the *percentage* of daily sales that appellant's customers paid by credit card. In other words, CDTFA was not looking at daily sales volume, but for a ratio—that is, the relationship between sales paid for by credit card versus cash. CDTFA then divided appellant's audited credit card sales for the audit period, which were compiled from appellant's own bank records, by this percentage/ratio (21.62 percent) to arrive at audited taxable sales. At the oral hearing, appellant had claimed that credit cards sales amounted to over half of its total sales, even up to 75 percent, outside of CDTFA's five days of observation. However, appellant has not submitted any evidence that supports such a high credit card ratio outside the holiday season. Neither has appellant otherwise established that its customers tended to make more purchases with cash during the holiday season versus other times of the year (which would mean that the 21.62 credit card ratio was unusually low). Thus, appellant's first argument fails to undermine the validity of CDTFA's audit method.

Regarding appellant's contention that CDTFA deliberately delayed the observation tests, we have examined the record and find that it reflects the standard, if slightly contentious, push-pull dynamic of a normal audit. Throughout the second half of 2016, both parties communicated

regularly: CDTFA's auditor sought records, attempted to verify information, and posed clarifying questions to appellant's representative; at the same time, appellant and its representative sought to supply records, attempted to explain away any perceived discrepancies, and provided clarifying answers. Additionally, both parties were busy: CDTFA's auditor with other audits; and appellant's representative with quarterly tax filings for clients. Both parties were also out of the office at various times during the second half of 2016 for vacation, training, and holidays[10]—absences that we find to be reasonable. Based on these facts, we do not find any evidence that CDTFA deliberately delayed the observation tests; if there was any delay here, it is attributable to both parties and was an unintended byproduct of their busyness.

Regarding appellant's contention that the holiday season is its busiest, we reiterate that whether appellant was busy or not is irrelevant to the credit card projection method, the audit method employed by CDTFA. This audit method sought to establish the ratio of credit card sales to total sales, and appellant has failed to supply any proof that this ratio is not representative of the audit period. Moreover, we note that, on the original BOE-805, in the space for documenting appellant's busy/slow months, appellant's representative wrote "N/A," indicating that appellant had no busy or slow months.[11] And later, when appellant updated the BOE-805, it did not change any information regarding its busy/slow months, reaffirming that its sales volume was consistent throughout the year. Finally, we note that both the original and updated BOE-805s indicate that appellant consented to both the initial observation test dates in November 2016, as well as the additional observation test days in December 2016, and there is no indication in the record that appellant objected to either set of dates.[12]

Based on the above, we conclude that appellant's first argument fails to undercut CDTFA's determination, is not supported by the record, and thus is not persuasive.

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[10] Per the BOE-414Z: appellant's representative was on vacation from August 5 through 15, 2016; CDTFA's auditor was on vacation in early September 2016 and out of town for training in late September 2016; appellant was out of town in early October 2016; appellant's representative was outside of the country from November 28 to December 18, 2016; and both appellant and CDTFA's auditor were on vacation in late December 2016.

[11] At the oral hearing, we asked appellant why, if holiday months were busier, that fact was not noted on the BOE-805 executed by appellant's representative. Appellant did not directly answer the question, but only indicated that its representative wanted, and pushed for, the audit to be finished before the representative's busy tax season started in January 2017.

[12] When asked about agreeing to the observation test dates at the oral hearing, appellant claimed, "Agreed means they told me we come on this day. Do you have any objection? What objection could I put. It means I can't have a reason to object [to] that. They kept pushing for the date, you know." (Oral Hearing Transcript p. 26.)

Appellant's Second Argument: Audit Result Is Unreasonable

Initially, appellant asserted that the amount of taxable sales established in the audit represents a gross profit margin of 2,000 percent, which appellant contends is completely unreasonable. Subsequently, appellant argues that audited unreported taxable sales of $1,552,597, which purportedly represents a gross profit margin of 94 percent, is unreasonable and overstated because, if appellant were so profitable, it would not have had to close its remaining two smoke shops due to an inability to pay rent. In support of its inability to pay rent, appellant submitted email correspondence with its landlord.

In response, CDTFA notes that a comparison of audited taxable sales of $892,744 with estimated merchandise purchases of $459,136, both for 2014, shows a markup of 94.44 percent, which is higher than it expected. However, because appellant's merchandise purchase information is incomplete, CDTFA contends that appellant's merchandise purchases for 2014 likely were significantly higher than the estimated amount of $459,136, which would result in a lower computed markup.

Here, appellant's merchandise purchase information is incomplete, so we conclude that a computed markup percentage, based on a comparison of audited taxable sales with estimated merchandise purchases, would not be helpful in determining whether audited taxable sales are reasonable. Further, CDTFA attempted different audit methods to confirm that the results of its credit card projection method were reasonable, but the available records were not sufficient to enable it to perform a different audit method with any reliability. We thus find that CDTFA based the results of its credit card projection method on the best available evidence of appellant's sales. In the absence of any documentation or other evidence from which a more accurate determination may be made, we find appellant's second argument on appeal unpersuasive.

Appellant's Third Argument: No Negligence/Evasion = No Liability

Appellant argues that it is inconsistent for CDTFA to find that appellant underreported taxable sales, while finding no evidence of negligence or intent to evade tax.

If any part of the deficiency for which a deficiency determination is made is due to negligence or intentional disregard of the Sales and Use Tax Law or authorized rules and regulations, a penalty of 10 percent of the amount of the determination shall be added thereto. (R&TC, § 6484; Cal. Code Regs., tit. 18, § 1703(c)(3)(A).) Generally, a penalty for negligence

or intentional disregard should not be added to deficiency determinations associated with the first audit of a taxpayer in the absence of evidence establishing that any bookkeeping and reporting errors cannot be attributed to the taxpayer's good faith and reasonable belief that its bookkeeping and reporting practices were in substantial compliance with the requirements of the Sales and Use Tax Law or authorized regulations. (Cal. Code Regs., tit. 18, § 1703(c)(3)(A).)

If any part of the deficiency for which a deficiency determination is made is due to fraud or an intent to evade the Sales and Use Tax Law or authorized rules and regulations, a penalty of 25 percent of the amount of the determination will be added thereto. (R&TC, § 6485; Cal. Code Regs., tit. 18, § 1703(c)(3)(C).)

Here, CDTFA's determination that there was no evidence of negligence or fraud on appellant's part in connection with appellant's underreporting was made in the context of assessing whether negligence or fraud/evasion penalties were warranted. These penalties are contingent upon the existence of a deficiency. However, contrary to appellant's argument, the reverse is not true: the existence of a deficiency or underreporting is not contingent upon the existence of negligence, fraud, or an intent to evade. It is not inconsistent to have the former without the latter. As relevant here, California Code of Regulations, title 18, section 1703(c)(3)(A) states that, in general, negligence penalties should not be added to deficiency determinations associated with a taxpayer's first audit. And, in fact, there are many cases where there is underreporting, but no negligence or fraud/evasion penalties assessed. (See, e.g., *Appeal of AMG Care Collective*, *supra*.) Accordingly, we conclude that appellant's third argument lacks merit.

Appellant's Fourth Argument: Questionable Markup Method Results

Appellant claims that CDTFA's auditor obtained from appellant's vendors taxable merchandise purchase information that allegedly showed additional purchases that were not recorded in its 1Q16 merchandise purchase invoices, but CDTFA never shared that information with appellant, so appellant could not verify that information. Appellant also notes that some of its vendors do not require identification to make purchases, speculating that unknown third parties made taxable purchases that were then ascribed to appellant in its vendors' records, thereby improperly inflating the results of the markup test.

Here, CDTFA abandoned its markup analysis in favor of the credit card projection method to establish audited taxable sales. Because appellant's argument relates to an audit

method that CDTFA did not use to establish unreported taxable sales, we conclude that this argument is not relevant.

In summary, we find that CDTFA has used a recognized and accepted audit method, as well as the best available evidence, to establish audited taxable sales, but appellant has not provided support for any adjustments.

HOLDING

No reduction to the amount of unreported taxable sales is warranted.

DISPOSITION

CDTFA's action in denying the petition for redetermination is sustained.

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Andrew Wong
Administrative Law Judge

We concur:

DocuSigned by:
Daniel Cho
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Daniel K. Cho
Administrative Law Judge

DocuSigned by:
Nguyen Dang
77AFD3EA552843B...
Nguyen Dang
Administrative Law Judge

Date Issued: 3/17/2021