OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 21057870
	) CDTFA Case ID: 226-025
STRAIN BALBOA CAREGIVERS, INC.	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Bryan J. Thomas, Attorney
For Respondent:	Jason Parker, Chief of Headquarters Operations
For Office of Tax Appeals (OTA):	Deborah Cumins, Business Taxes Specialist III

K. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Strain Balboa Caregivers, Inc. (appellant) appeals a Decision, as amended by a Supplemental Decision issued by the California Department of Tax and Fee Administration (respondent),[1] which denied, in part, appellant's petition for redetermination of a December 14, 2016 Notice of Determination (NOD).[2] The NOD is for tax of $1,317,450.73, a negligence penalty of $131,745.09, and applicable interest, for the period January 1, 2013, through December 31, 2015 (liability period). In its Supplemental Decision, respondent reduced the tax from $1,317,450.73 to $1,193,574.00 and the penalty from $131,745.09 to $119,357.43, but otherwise denied the petition.

[1] Sales taxes were formerly administered by the State Board of Equalization (BOE). In 2017, functions of BOE relevant to this case were transferred to respondent. (Gov. Code, § 15570.22.) When this Opinion refers to acts or events that occurred before July 1, 2017, "respondent" shall refer to BOE.

[2] Appellant made payments against the liability and filed what we view as a protective claim for refund to protect its right to a refund in the event adjustments to the liability result in an overpayment. However, OTA has no jurisdiction over claims for refund for any reporting periods for which the tax has not been paid in full. (See *California Department of Tax and Fee Administration v. Superior Court* (2020) 48 Cal.App 5th 922, 932.)

This matter is being decided on the basis of the written record because appellant waived the right to an oral hearing.

ISSUES

1. Whether further reduction to the audited measure of unreported taxable sales is warranted.
2. Whether respondent correctly imposed the negligence penalty.

FACTUAL FINDINGS

1. Beginning in July 2007, and continuing through the liability period and to date, appellant operated a medical marijuana dispensary (the business) in California. Before the liability period, the business was in Van Nuys. According to appellant, the business moved to Encino in 2012, closed that location in March 2013 and operated as a delivery service only until opening a retail location in downtown Los Angeles in December 2013, and finally moved to its current location in Chatsworth in April 2014.
2. Respondent audited appellant once before the liability period at issue in this appeal. During the first audit, which also disclosed a deficiency, respondent reminded appellant of its obligation to maintain adequate books and records.
3. During the liability period, appellant's business was open every day, including weekends and most holidays, from 10:00 a.m. to 8:00 p.m.
4. During the liability period, appellant reported total and taxable sales of $2,197,322.00, claiming no deductions. Appellant reported gross sales of $5,319.00 for the first quarter of 2013 (1Q13) and gross sales of less than $1,500.00 for each of the following three quarters. Appellant reported gross sales of $124,933.00 for 1Q14 and steadily increasing gross sales during the successive remaining quarters of the liability period, with reported gross sales of $424,000.00 for 4Q15.
5. According to respondent, appellant provided the following for audit: federal income tax returns for 2013 and 2014; sales and use tax returns for the liability period; a sales journal for the years 2014 and 2015; bank statements for the liability period; and the total amount of sales on May 9, 2016, for the hour during which respondent conducted an observation test inside the business.

6. In its preliminary review, respondent found that the total sales reported on sales and use tax returns substantially reconciled with amounts reported on the federal income tax returns for 2013 and 2014 and with the sales recorded in the sales journal for 2014 and 2015.
7. Respondent also found that appellant claimed a deduction for "sales tax expense" on its 2014 federal income tax return of $118,927.00, which exceeded the sales tax reimbursement that appellant reported on its sales and use tax returns by $53,644.00 for the same period.
8. Respondent used the taxable sales reported on appellant's sales and use tax returns and the costs of goods sold reported on appellant's federal income tax returns to compute book markups[3] of 85 percent for 2013 and 36 percent for 2014.
9. Respondent found that appellant's bank deposits, net of sales tax included, totaled $477,718.00 for the liability period, which was $1,719,604.00 less than reported taxable sales for the same period ($2,197,322.00). Based on this information, respondent found that it could not rely on a bank deposit analysis.
10. Respondent concluded that further investigation was warranted and decided to establish audited taxable sales using observation tests.
11. Respondent observed the business for 13 periods on 12 days.[4] Each observation, which occurred during the period October 23, 2015, through May 9, 2016, lasted approximately one hour.[5] All the observations, except one observation on May 9, 2016, were conducted from outside the business. Respondent states that during each observation period, it only

[3] "Markup" is the amount by which the cost of merchandise is increased to set the retail price. For example, if the retailer's cost is $.70 and it charges customers $1.00, the markup is $0.30. The formula for determining the markup percentage is markup amount ÷ cost. In this example, the markup percentage is 42.86 percent (.30 ÷ .70 = 0.42857). A "book markup" (sometimes referred to as an "achieved markup) is one that is calculated from the retailer's records.

[4] Two of the observation periods were on the same day, November 10, 2015.

[5] The observations were conducted on two Mondays (October 26, 2015, at 1:00 p.m. - 2:00 p.m., and May 9, 2016, at 12:06 p.m. - 1:06 p.m.), one Tuesday (two observation periods on November 10, 2015, at 11:51 a.m. - 12:51 p.m. and at 2:33 p.m. - 3:33 p.m.), one Wednesday (November 18, 2015, at 6:03 p.m. - 7:07 p.m.), two Thursdays (November 5, 2015, at 2:01 p.m. - 3:05 p.m. and February 18, 2016, at 11:20 a.m. - 12:20 p.m.), four Fridays (October 23, 2015, at 3:10 p.m. - 4:12 p.m., November 13, 2015, at 4:06 p.m. - 5:07 p.m., November 20, 2015, at 1:06 p.m. - 2:15 p.m., and December 18, 2015, at 7:00 p.m. - 8:00 p.m.), and two Saturdays (December 5, 2015, at 2:55 p.m. - 3:56 p.m. and December 12, 2015, at 12:19 p.m. - 1:20 p.m.). No observations were conducted on Sunday.

counted persons that were observed entering and then exiting the business with a bag as customers. If two or more persons arrived and entered together, and then exited together with a purchase, they were counted as a single customer. Respondent observed 991 customers over approximately 13 hours and calculated an average of 76.23 customers per hour (991 ÷ 13 =76.230).

12. Respondent compared the observation results for the period October 23, 2015, through December 18, 2015, to appellant's sales journals for that same period. For those days, respondent observed an average of approximately 78 customers per hour. By comparison, appellant's sales journals reflected an average of 11 customers per hour.[6]

13. On Monday, May 9, 2016, respondent conducted an observation inside the business and observed sales to 62 customers, totaling $2,936.00. This amounts to an average price of $47.35 per sale, which the parties agreed to use as the average sales price for the liability period.

14. Respondent used the observed average number of customers per hour, the agreed average sales price, the number of hours of operation per day, and 90 days of operation[7] to compute audited taxable sales of $3,248,663.00 for 4Q15,[8] which exceeded appellant's reported taxable sales of $424,000.00 for that same quarter by $2,824,663.00. Respondent computed a percentage of error of 666.19 percent, which it applied to appellant's reported taxable sales to compute an understatement of $14,638,340.00.

15. Respondent found that appellant was negligent based on the size of the understatement and appellant's failure to maintain and provide books and records adequate for sales and use tax purposes.

16. On December 14, 2016, respondent issued the NOD for tax of $1,317,450.73. Respondent also imposed a negligence penalty of $131,745.09.

17. On January 12, 2017, appellant filed a petition for redetermination, disputing the entire liability.

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[6] The lowest average number of customers per hour observed by respondent on any given day was 59.5 on Mondays.

[7] There were 92-days in 4Q15. Respondent used 90 days, rather than 92, which allows for reduced hours or closures on holidays.

[8] While the audit work papers indicate respondent used 76 for the number of customers, it actually used the figure prior to rounding of 76.23 (991 ÷ 13 = 76.230).

18. On December 13, 2019, respondent issued its Decision, which ordered a reaudit to correct a computational error in calculating the average number of customers per hour. Specifically, the Decision found that it used one hour observation increments in calculating the average customers per hour when, in fact, several observations were for more than 60 minutes. The Decision found that the average number of customers per hour should be computed using the minutes of observation. That revision reduced the average number of customers per hour from 76.230 per hour to 74.14 per hour (which was rounded to 74).
19. Respondent conducted a reaudit based on the Decision, which reduced the tax from $1,317,450.73 to $1,273,075.00, and the negligence penalty from $131,745.09 to $127,307.47.
20. On September 15, 2020, appellant filed a Request for Reconsideration.
21. On April 26, 2021, respondent issued a Supplemental Decision sustaining its Decision and ordering no additional adjustments. This timely appeal followed.
22. During this appeal before OTA, respondent concluded that an adjustment was warranted for individuals who entered the business but did not make a purchase. This adjustment reduced the audited number of customers per hour by five percent from 74 to 70 (74 x .95 = 70.3, which respondent rounded to 70). The adjustment resulted in a further reduction to the percentage of error from 643.75 percent to 603.55 percent.
23. On July 29, 2021, respondent notified appellant that the tax and penalty had been reduced to $1,193,574.00 and $119,357.43, respectively.

DISCUSSION

Issue 1: Whether further reduction to the audited measure of unreported taxable sales is warranted.

California imposes sales tax on a retailer's retail sales of tangible personal property sold in this state, measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, §§ 6012, 6051.) For the purpose of the proper administration of the Sales and Use Tax Law and to prevent the evasion of the sales tax, the law presumes that all gross receipts are subject to tax until the contrary is established. (R&TC, § 6091.) It is the retailer's responsibility to maintain complete and accurate records to support

reported amounts and to make them available for examination. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).)

When respondent is not satisfied with the amount of tax reported by the taxpayer, or in the case of a failure to file a return, respondent 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, respondent has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Talavera*, 2020-OTA-022P.) Once respondent has met its initial burden, the burden of proof shifts to the taxpayer to establish that a result different from respondent's determination is warranted. (*Ibid*.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid*.)

Appellant disputes the findings of respondent's audit. Appellant asserts that it provided complete and accurate books and records for audit. Appellant contends that respondent never requested source documents or any other additional documents. Appellant also argues that there was no discrepancy that warranted respondent's refusal to accept the reported amounts. Appellant asserts that respondent focused on explainable inconsistencies during the audit as a pretext to justify the use of an indirect audit method. Appellant also argues that observation tests result in an overstated audit liability because they include unsubstantiated presumptions and unrepresentative samples.

Appellant acknowledges that there may be a discrepancy between reported taxable sales and appellant's bank deposits. However, appellant asserts that any such discrepancy does not justify respondent's refusal to accept appellant's books and records. Appellant asserts that banking is difficult for cannabis businesses. Appellant asserts that it is not unusual for cannabis businesses to have "an uneven banking deposit history." Appellant also alleges that respondent is aware of the issues that cannabis businesses have in opening and maintaining bank accounts. Appellant requests that the observation test be disregarded, and that its liability instead be based on a thorough examination of its books and records.

As to the observation test, appellant asserts that the observation periods are not representative of appellant's business. Appellant asserts that respondent chose high volume days (Friday evenings, weekends, pay days, and days near holidays), which allowed respondent to overstate the audited taxable sales.

Respondent is not required to accept the taxpayer's books and records as conclusive evidence of what they purport to represent, even when the books and records are in agreement with each other and with sales and use tax returns. (*Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 615.) Respondent has the responsibility for administering the Sales and Use Tax Law, and the obligation to ensure, to the extent possible, that taxes and penalties are correctly calculated. OTA does not dictate the methodology that respondent must use. However, OTA also does not dictate the arguments a taxpayer must use with regard to audit methodologies on appeal. Here, if respondent demonstrates that its determination, based on an indirect audit methodology, is reasonable and rational then appellant can argue that a direct audit of its books and records prove a more accurate measure of tax.

As stated above, respondent found that appellant's sales and use tax returns substantially reconciled with appellant's federal income tax returns for 2013 and 2014, and with appellant's sales journal for 2014 and 2015. However, respondent also found that appellant claimed a deduction on its 2014 federal income tax return for sales tax expense of $118,927.00, which was $53,644.00 more than appellant's reported sales tax of $65,283.00 for that year. The difference between the deduction that appellant claimed on its federal income tax return and the amount that appellant reported on its sales and use tax return is evidence of an understatement of taxable sales.[9]

Additionally, respondent computed book markups of 85 percent for 2013 and 36 percent for 2014. Appellant could not explain the variance in its markup from year to year. Respondent also found that appellant's reported taxable sales of $2,197,322.00 for the liability period exceeded appellant's bank deposits for the same period by $1,719,604.00. We note appellant's explanation that banking is difficult for the cannabis industry. However, the potential inability of cannabis businesses to maintain bank accounts is not evidence that the business' books and records are reliable. Instead, the fact that appellant's reported taxable sales exceeded appellant's bank deposits is evidence that appellant's bank statements are not reliable for audit purposes.

Next, we consider the assertions that appellant provided adequate records for the audit and that respondent never requested source documents. We first note the evidence submitted by appellant does not include source documents, such as actual sales invoices, cash register or

[9] Sales tax of $53,644.00 corresponds to a taxable measure of $596,044.00. The reported sales tax of $65,283.00 corresponds to a reported taxable measure of $725,391.00.

point-of-sale system tapes, or any other source documentation for sales. Furthermore, the evidence shows that respondent repeatedly requested such records, as shown in the following: respondent's February 18, 2016 letter to appellant; entries made in respondent's Assignment Activity History (Form 414Z in the audit work papers) on June 7, 2016, and June 10, 2016, documenting verbal requests for documentation; and in a November 29, 2016 Report of Discussion of Audit Findings. We find that the records provided by appellant were not sufficient to meet its record retention obligations under R&TC section 7053, or its requirement to provide records for a sales and use tax audit.[10]

Regarding the observation test, we again note that respondent 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 this case, respondent conducted an observation test consisting of twelve observations from vantage points outside of the business and one observation from inside the business. Appellant has not argued that this aspect of the test weighed unfairly against it, and there are legitimate reasons why cannabis retailers and respondent's auditors would prefer to conduct most observation testing from vantage points outside of the business premises. We find that this was a rational and reasonable way to conduct the observations. We also find that respondent used a rational method of counting customers, which likely resulted in a reasonable estimate of the number of customers.

Nevertheless, we have some concerns about the testing days and are persuaded that respondent's use of four Friday observation periods resulted in an unrepresentative estimate of the number of customers that appellant served per hour. Here, the evidence indicates that respondent's testing was unreasonably concentrated on what appear to be the busiest times. The four highest customer counts consist of three taken on Friday afternoons between 3:00 p.m. and 7:00 p.m. (82.3, 86.5, and 116 customers per hour taken in that order) and one taken on Saturday afternoon between 2:55 p.m. and 3:56 pm (95.41 customers per hour). This accounts for almost 31 percent of the observations. Respondent has not provided any explanation as to why the observations are concentrated on these periods, which were predictably busy times. By comparison, the only other observation done after 3:00 p.m. was on a Wednesday beginning at 6:00 p.m. and lasting for 1.07 hours. In that instance respondent calculated 67.5 customers

[10] Also, as we discuss in more detail below, the law, which appellant is presumed to know, clearly informs retailers that they are required to maintain and provide for audit "receipts, invoices, cash register tapes, or other documents of original entry supporting the entries in the books of account." (Cal Code Regs., tit. 18, § 1698(b)(1).)

per hour, a significant difference from the Friday observations. We find that respondent's inclusion of four Friday observation periods probably resulted in an unrepresentative sample of appellant's business.

However, we also find that respondent can correct this issue by deleting the highest (116) of the Friday observation periods. To provide context the 116-person observation is 42 persons (or 156 percent) more than the average customers observed per hour. It is also approximately 21 persons more than the next highest observation. Based on these differences, we find that the 116-person observation should be deleted as it is less representative of the business. [11] With this correction, which respondent will be directed to make below, we find that in all other respects the evidence shows a reasonable and rational basis for the determination. Consequently, appellant has the burden to show that additional adjustments are warranted.

We have already discussed most of appellant's arguments, above. Appellant did not provide adequate records for the audit. The books and records that appellant did provide were inconsistent, unreliable, and indicated substantial underreporting. Aside from the erroneous concentration of observation test periods on Fridays, which we have already addressed, appellant offers no argument or evidence to support its assertion that observation tests in general are, or that this particular observation test was, inaccurate or unreliable. Finally, appellant makes no effort to prove a more accurate measure of tax. Appellant's request that we base its liability on the books and records provided ignores the concerns we discussed above with those books and records. The taxpayer cannot carry its burden simply by asking OTA to find unidentified errors in respondent's determination. (*Appeal of Amaya*, 2021-OTA-328P.) To carry its burden of proof, appellant should have analyzed the evidence, identified any alleged errors, and shown how appellant's position calculates a more accurate measure.

For the reasons stated above, we find that a further reduction to the audited measure of unreported taxable sales is warranted, which respondent shall calculate by deleting the highest Friday customer count (116) from the calculation of the average hourly customer count and otherwise recalculating the percentage of error in the manner used in its last reaudit.

[11] We decline to reduce the number of Friday observations any further. Based on their proximity to each other and the overall average calculated number of customers during the observation tests, we find that the remaining Friday observations more accurately reflect the business operations."

Issue 2: Whether respondent correctly imposed the negligence penalty.

R&TC, section 6484 provides that if any part of the deficiency for which a deficiency determination is made is due to negligence or intentional disregard of the law or authorized rules and regulations, a penalty of 10 percent of the amount of the determination shall be added thereto. Although the term "negligence" in not specifically defined in the Sales and Use Tax Law, it is a common legal concept and is generally defined as a failure to act as a reasonably prudent person would have acted under similar circumstances. (*Acqua Vista Homeowners Assn. v. MWI, Inc.* (2017) 7 Cal. App. 5th 1129, 1157.)

Taxpayers are required to maintain and make available for examination on request by respondent, or its authorized representative, all records necessary to determine the correct tax liability under the Sales and Use Tax Law and all records necessary for the proper completion of the sales and use tax returns. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).) Such records include but are not limited to: (a) the normal books of account ordinarily maintained by the average prudent businessperson engaged in the activity in question; (b) bills, receipts, invoices, cash register tapes, or other documents of original entry supporting the entries in the books of account; and (c) schedules or working papers used in connection with the preparation of the tax returns. (Cal Code Regs., tit. 18, § 1698(b)(1).) Failure to maintain and keep complete and accurate records, including all bills, receipts, invoices, or other documents of original entry supporting the entries in the books of account, is evidence of negligence. (Cal Code Regs., tit. 18, § 1698(k).) A negligence penalty also can be based on reporting errors, particularly when errors are continued from one audit to the next. (*Independent Iron Works, Inc. v. State Board of Equalization* (1959) 167 Cal.App.2d 318, 321-324.)

During its appeal with respondent, appellant argued that the negligence penalty should not be applied because the true amount of understatement was not sufficiently large to warrant a penalty. Appellant has not specifically disputed the negligence penalty in its appeal to OTA, though the stated appealed amount includes the penalty.[12] Thus, we infer that appellant disputes the negligence penalty.

The evidence establishes that appellant knew that it should maintain and provide adequate records, including source documents evidencing sales, but it failed to do that.

[12] The stated appealed amount also includes interest, but appellant has made no argument regarding interest abatement, and we find no support for interest abatement in the record. (R&TC § 6593.5.)

Appellant is presumed to know what the law required in this regard. (*Arthur Andersen, LLP v. Superior Court* (1998) 67 Cal.App.4th 1481, 1506-1507.) Appellant was reminded of this obligation during respondent's first audit. Still, notwithstanding the fact that it knew it must maintain and provide all books and records required to determine its tax liability, appellant did not provide required source documents, and the documents that it did provide were inconsistent with each other and, as such, unreliable.[13] This was, at a minimum, negligence.[14]

The evidence also shows that appellant's reporting was grossly inaccurate. Although we have found that an adjustment to the liability is warranted, the error percentage remains substantial, somewhere near 560 percent,[15] and the audited measure of unreported taxable sales should still exceed $12,000,000.00. In other words, it is likely that appellant failed to report taxable sales at the rate of $4,000,000.00 per year, or over $333,000.00 per month, or almost $11,000.00 per day. This level of underreporting does not happen without the knowledge of the business and cannot happen unless the business is at least negligent.

We find that respondent correctly imposed the negligence penalty.

[13] For example, the limited sales reports provided by appellant indicate that it recorded only a small fraction of its sales.

[14] A finding that a taxpayer intentionally disregarded the law would also support the penalty, but we need not make that finding because we find negligence.

[15] This is an estimate. Respondent will do the final calculation.

HOLDINGS

1. A further reduction to the audited measure of unreported taxable sales is warranted.
2. Respondent correctly imposed the negligence penalty.

DISPOSITION

We direct respondent to redetermine appellant's liability by deleting the highest Friday customer count (116) from the calculation of the average customer count per hour and otherwise recalculating the percentage of error in the manner used in its last reaudit, which will result in lower tax, penalty, and interest amounts. In all other respects, respondent's Decision, as amended by its Supplemental Decision, is sustained.

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Keith T. Long
Administrative Law Judge

I concur:

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Andrew J. Kwee
Administrative Law Judge

M. GEARY, concurring in part and dissenting in part:

I agree with the majority's analysis regarding the audit and with the finding that respondent's inclusion of four Friday observation periods probably resulted in an unrepresentative sample of appellant's business. I also agree that the appropriate remedy is the inclusion of fewer Friday counts. However, I disagree with the majority's conclusion that deleting the highest Friday customer count is the correct remedy.

I see no evidence to support the majority's conclusion that the highest Friday count of 116 customers per hour is "less representative of appellant's business." On the contrary, it is not surprising that appellant's customer counts appeared to trend higher on Friday and Saturday.[1] Those higher counts are not outliers. They are representative of appellant's busy times and should be included in the mix. I would have deleted the 1:00 p.m. - 2:00 p.m. and the 3:00 p.m. - 4:00 p.m. Friday counts, not because these two are the lowest, but because their deletion evens out the daily counts, with two counts for five of the six days tested,[2] and because two comparable afternoon time periods (12:00 p.m. - 1:00 p.m. and 2:00 p.m. - 3:00 p.m.) are represented in Saturday counts.

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Michael J Geary
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Michael F. Geary
Administrative Law Judge

Date Issued: 3/14/2022

[1] Friday counts (per hour) were 70.43 (at 1:00 p.m. - 2:00 p.m.), 82.3 (at 3:00 p.m. - 4:00 p.m.), 86.5 (at 4:00 p.m. - 5:00 p.m.), and 116 (at 7:00 p.m. - 8:00 p.m.). Saturday counts (per hour) were 66.88 (at 12:00 p.m. - 1:00 p.m.) and 95.41 (at 2:00 p.m. - 3:00 p.m.).

[2] There was only one count on a Wednesday.