OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 20127048
	) CDTFA Case ID 094-025
DIVINE WELLNESS CENTER, INC.	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Richard Robinson, Attorney Bernard Bunning, CPA Bruce Smith, CPA Gary Petrosyan, CEO
For Respondent:	Randy Suazo, Hearing Representative Chad Bacchus, Tax Counsel IV Jason Parker, Chief of Headquarter Ops.
For Office of Tax Appeals:	Craig Okihara, Business Taxes Specialist III

J. LAMBERT, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Divine Wellness Center, Inc. (appellant) appeals a Decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] on appellant's petition for redetermination of the Notice of Determination (NOD) dated June 29, 2017.[2] The NOD is for $588,845.28 in tax, applicable interest, and a negligence penalty of $58,884.58, for the period April 1, 2013, through March 31, 2016 (liability period).

Pursuant to its Decision, CDTFA performed a second reaudit which reduced the tax to $408,126 and resulted in a corresponding reduction to the penalty.

[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 CDTFA. (Gov. Code, § 15570.22.) For ease of reference, when this Opinion refers to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to BOE.

[2] The NOD was timely issued because on December 20, 2016, appellant signed the most recent in a series of waivers of the otherwise applicable three-year statute of limitations for the period April 1, 2013, through March 31, 2014, which allowed CDTFA until July 31, 2017, to issue an NOD. (R&TC, §§ 6487(a), 6488.)

Office of Tax Appeals (OTA) Administrative Law Judges Josh Lambert, Suzanne B. Brown, and Andrew J. Kwee held an oral hearing for this matter in Sacramento, California, on October 19, 2022. At the conclusion of the hearing the record was closed, and this matter was submitted for an opinion.

ISSUES

1. Whether additional adjustments to the amount of unreported taxable sales are warranted.
2. Whether appellant is liable for the negligence penalty.

FACTUAL FINDINGS

1. Appellant operated a medical marijuana dispensary selling cannabis products for medicinal use. Appellant was issued its seller's permit with an effective start date of April 22, 2007.
2. Appellant was initially located in North Hollywood, California, but closed that site on December 13, 2013. Appellant relocated to Canoga Park, California, in February 2014.
3. Appellant's business hours were from 10:00 a.m. to 8:00 p.m., Monday through Sunday.
4. Appellant was previously audited for the period January 1, 2008, through December 31, 2010 (prior audit period).[3]
5. As to the current liability period, CDTFA prepared an audit and a revised audit. The NOD is based on the revised audit dated May 31, 2017.
6. For the liability period, appellant reported on its sales and use tax returns (SUTRs) total sales of $1,320,292, claiming deductions of $55,260 for sales tax reimbursement included in reported total sales, resulting in reported taxable sales of $1,265,032.
7. During the audit, appellant provided its 2013 federal income tax return (FITR);[4] general ledgers for April 1, 2013, through December 31, 2013, and April 1, 2014, through December 31, 2015; a point-of-sales (POS) sales summary for January 1, 2016, through March 31, 2016 (1Q16); and bank statements for 2015.
8. Appellant stated that POS sales summaries were used to prepare the general ledgers which in turn were used to report sales for the SUTRs and FITR. Appellant did not

[3] The prior audit resulted in a deficiency which was reduced in a subsequent reaudit.

[4] Appellant stated it had not filed its 2014 and 2015 FITRs at the time of the audit fieldwork.

provide source documentation, such as sales invoices, cash register tapes, or merchandise purchase invoices supporting cost of goods sold (COGS), for the liability period. CDTFA found that the provided books and records were inadequate for sales and use tax recordkeeping purposes.

9. CDTFA noted that total sales recorded in the general ledgers exceeded total sales reported on the SUTRs by $51,811. Appellant did not provide documentation to explain the reason for the difference. CDTFA found the difference was an indication that reported sales may be understated and additional testing was warranted.

10. Using the bank statements appellant provided for 2015, CDTFA compiled bank deposits of $79,243. CDTFA compared bank deposits to gross sales of $618,108 that appellant reported on its SUTRs for 2015, and found that reported total sales exceeded bank deposits by $538,865. After determining that appellant did not deposit all cash sales proceeds into its bank accounts, CDTFA discontinued further analysis of bank deposits.[5]

11. CDTFA conducted an observation test. During 1Q16, CDTFA visited appellant's business on 12 different occasions. From outside of appellant's business, CDTFA counted the number of people who entered the business during 12 one-hour periods on various days of the week at various times of appellant's business hours (observation day). CDTFA computed an average of 27 customers per hour entered the business, which was significantly more than the average number of 9 customers per hour based on recorded sales from the 1Q16 POS sales summaries. CDTFA believed that the large difference was evidence that recorded sales were understated.

12. Based on its discussions with appellant, CDTFA excluded one observation day with an unusually high number of people when compared to the other days.[6] Thus, for the 11 remaining observation days, CDTFA computed an average of 24 customers per hour entered the business. Based on its discussions with appellant, CDTFA reduced the

[5] CDTFA also compared total sales reported on the SUTRs for 2013 to the corresponding COGS reported on the FITR and computed a book markup of 177.39 percent. However, because appellant did not provide purchase journals and merchandise purchase invoices to verify COGS, CDTFA was unable assess the adequacy of the book markup or perform a markup analysis to verify reported taxable sales.

[6] On Friday, February 19, 2016, CDTFA counted 59 people entering the business.

computed average for each preceding quarter by one customer per hour starting with 24 customers per hour in 1Q16 and ending with 13 customers per hour in 2Q13.

13. Using the POS sales summaries appellant provided, CDTFA compiled the recorded number of sales and amounts for the observation days. In total, CDTFA computed an average sale per customer of $56 (sales tax included).[7] CDTFA noted that the average sale per customer of $50 based on recorded sales from the 1Q16 POS sales summary was similar and that the average sale per customer of $56 was reasonable.

14. Based on its discussions with appellant, CDTFA decided to use the observation results to calculate audited taxable sales for 3Q15 and 1Q16 only. CDTFA multiplied the number of customers per day by the average sale per customer of $56 to compute the average sales per day, which was then multiplied by the number of days operating per quarter. After a reduction by the sales tax rate, CDTFA computed audited taxable sales of $1,035,163 for 3Q15 and $1,129,268 for 1Q16.

15. For the remaining quarters, CDTFA estimated appellant's taxable sales based on appellant's projected growth from trends in prior reporting, starting with 1Q08, the beginning of the liability period for the prior audit, through 1Q16. Based on that information, CDTFA calculated growth rates to determine unreported taxable sales for the remainder of the liability period.

16. In consideration of appellant's move, CDTFA used audited taxable sales and appellant's SUTR for 1Q14 to determine a growth rate of 77 percent. CDTFA applied the growth rate to audited taxable sales for 1Q14 of $198,434 to find an increase of $152,927 ($198,434 × 0.77). CDTFA added $152,927 to quarterly taxable sales for 2013 of $297,651 to compute audited taxable sales for 2Q14 of $450,579 ($297,651 + $152,927).

17. In total, CDTFA computed audited taxable sales of $7,807,757 for the liability period. Upon comparison to reported taxable sales of $1,265,032, CDTFA computed unreported taxable sales of $6,542,725 for the liability period.

18. CDTFA issued an NOD to appellant on June 29, 2017, with a tax liability of $588,845.28, applicable interest, and a negligence penalty of $58,884.58.

19. Appellant filed a timely petition for redetermination protesting the NOD in its entirety.

[7] The recorded number of sales ranged from 4 transactions to 16 transactions in an hour.

20. On February 19, 2016, CDTFA issued a Decision and Recommendation regarding the prior audit period. On that same date, CDTFA performed a first reaudit of the prior audit period.

21. In the appeal for the liability period before us here, CDTFA used audited taxable sales from the reaudit of the prior audit to establish appellant's projected growth trends and estimate appellant's taxable sales. Also in the instant case, CDTFA corrected an error in computing taxable sales for 2013 and to reduce the measure of audited taxable sales for 1Q14 in consideration of the fact that appellant changed locations and may have been closed for two months. In addition, to account for people who entered the business without making a purchase, CDTFA recommended that the computation of taxable sales include a 10 percent reduction to the number of hourly customers for 3Q15 and 1Q16, which would affect the computation of taxable sales for 4Q15.

22. Regarding the current liability period, CDTFA issued a Decision dated August 13, 2019, that ordered a reaudit be performed to make the above-mentioned changes but otherwise denying appellant's petition.

23. Pursuant to the first reaudit report dated September 18, 2019, CDTFA calculated audited taxable sales of $5,689,658. Upon comparison to reported taxable sales of $1,265,032, CDTFA computed unreported taxable sales of $4,424,626 for the liability period.

24. CDTFA prepared a second reaudit report dated February 14, 2020, to correct the computation of taxable sales for the 10 percent reduction to the number of hourly customers for 3Q15 and 1Q16 and the effect on computation of taxable sales for 4Q15. In total, the second reaudit increased audited taxable sales to $5,799,762. Upon comparison to reported taxable sales of $1,265,032, CDTFA computed unreported taxable sales of $4,534,730 for the liability period. Thus, the second reaudit reduced the measure of tax by $2,007,994 from $6,542,725 to $4,534,731 which is the measure in dispute.

25. On April 2, 2020, CDTFA notified appellant of the second reaudit results, and of its right to file an appeal within 30 days.

26. This timely appeal followed.[8]

[8] Appellant filed the instant appeal on June 18, 2020. It was timely filed because the filing deadline had been extended 60 days due to the COVID-19 pandemic.

DISCUSSION

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

California imposes sales tax on a retailer's gross receipts from the retail sale of tangible personal property in this state 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 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).)

When CDTFA is not satisfied with the amount of tax reported by the taxpayer, or in the case of a failure to file a return, 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. (*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 its burden of proof, a taxpayer must prove both (1) that the tax assessment is incorrect, and (2) the proper amount of tax. (*Appeal of AMG Care Collective*, 2020-OTA-173P.)

Appellant did not provide sufficient records to CDTFA to support the accuracy of its reported taxable sales. In particular, appellant did not provide source documents, such as sales invoices, cash register tapes, or any other source documentation for sales during the liability period. The unexplained differences between gross sales reported on the SUTRs and gross sales recorded in appellant's general ledgers indicated to CDTFA that reported taxable sales may have been understated. Therefore, CDTFA was justified to question reported taxable sales and to use a combination of indirect audit methods to compute appellant's sales. CDTFA performed an observation test which is a recognized and standard accounting procedure. (See *Appeal of AMG Care Collective*, *supra*.) In addition, it was reasonable for CDTFA to rely on sales trends computed from audited sales from the prior audit and reported sales through the current audit to

establish audited taxable sales. Therefore, CDTFA has met its initial burden to show that its determination was reasonable and rational, and the burden of proof shifts to appellant to show errors.

Appellant argues that CDTFA improperly relied upon the bank deposit analysis in determining that appellant did not deposit all cash from its sales into the bank account. However, the bank deposit analysis was not used in CDTFA's computation of audited taxable sales. Appellant states that it maintained a complete detailed log of all transactions in numerical order and instituted a new POS system on February 9, 2015, on the advice of CDTFA during the prior audit. Appellant asserts that the POS data was improperly ignored. However, the data from the observation test demonstrated that the new POS system did not record all sales transactions.[9] Therefore, the POS data is not reliable in computing total sales.

As to the observation test, appellant argues that CDTFA incorrectly presumed all persons entering the business made a purchase, and that as a result, CDTFA applied an erroneous average purchase amount. However, CDTFA made an adjustment in a reaudit to account for persons entering the business who did not make a purchase. CDTFA made a reduction to the number of hourly customers which modified the computation of taxable sales for 3Q15, 4Q15, and 1Q16. For instance, CDTFA's computation of an average number of customers of 24 per hour from the observation test was reduced to 22 customers per hour for 3Q15. Therefore, that average of 22 customers per hour allows for 8.33 percent of those entering who did not make a purchase (2 ÷ 24) who entered the business but did not make a purchase.

In addition, appellant provides a worksheet, Customer Hourly Recap, which summarizes appellant's own observation test of five days that found that 2,798 people entered the business and 868 people made purchases, and that 30.82 percent of customers who entered the business made a purchase and 69.18 percent did not. Appellant applied the 69.18 percentage to the number of customers CDTFA counted in its observation test and computed that an average of 8 customers per hour[10] would have made a purchase, which appellant notes is consistent with appellant's sales records provided for the days in CDTFA's observation test. Appellant also provides a worksheet, "Recomputation of Tax % of Error Calculation," wherein it computed

[9] According to the POS data, only one of three persons entering the facility were recorded as making purchases.

[10] (319 customers – [319 customers × 69.18 percent]) ÷ 12 hours = 8 customers

quarterly sales using an "actual" average sale price of $45, excluding sales tax, and an average of 8 customers per hour.

Using appellant's data for the five days in January 2017, OTA notes that 2,798 people entered the business and 868 people made purchases. This results in an average of 56 people per hour (2,798 people ÷ (50 hours = [5 days × 10 hours per day operated]) who entered the business and an average of 17 people per hour (868 people ÷ 50 hours) who made a purchase. Therefore, this data shows that on average, the facility can accommodate at least 56 people per hour (ranging from 52 to 58) and make an average of 17 sales per hour (ranging from 12 to 23), contrary to appellant's assertions that it could not service more than 8 customers in an hour on average. In addition, the average audited taxable sales for 2Q13 through 2Q15 based on the reported growth trend produces an average of 7 sales per hour, which is less than the 8 per hour argued by appellant. Finally, appellant does not provide source documentation supporting its observation test or the average sales price. Therefore, OTA does not place reliance on this data to support a reduction to the average number of customers per hour, and there is no basis to recommend changes to the audited average sales price of $56 computed using appellant's sales reports for the days corresponding to CDTFA's observation test.

Appellant argues that the physical restrictions of the building could not support more than 8 customers per hour, and that the facility has limited parking. However, the results of CDTFA's observation test show otherwise. In addition, appellant's POS records show that more than 8 customers were served in an hour; for instance, 13 and 16 customer sales were made in an hour on February 3, 2016, and March 4, 2016, respectively. OTA also notes that the "meet and greet" flyer advertising a special appearance by celebrities states, "Plenty of free parking in rear," which indicates that the facility could accommodate more parking than alleged by appellant.

Appellant contends that CDTFA did not take into consideration the change of locations and that the business was effectively closed and there were limited sales from December 2013, through February 2014. Appellant argues that in February 2014, it had a "soft opening" where it was not fully open and only served a limited number of people, and that it fully opened on May 16, 2015. Appellant provides the flyer for a "meet and greet" on May 16, 2015, to demonstrate the full opening of the business.[11] Appellant notes that CDTFA computed audited

[11] Appellant also provides a copy of its Canoga Park lease which began on February 15, 2014, and a copy of its building permit status information which indicated that the permit for the Canoga Park remodel was submitted on February 28, 2014, issued on May 9, 2014, and "final" on October 6, 2014.

sales for 1Q14 during the move based on audited sales for 4Q13 at the previous location. Appellant's CEO testified as to the process of transitioning locations and the lack of customers during that period, as the business was operated out of a garage.

However, CDTFA accounted for the change in sales due to appellant's move and the two months of closure during 1Q14. CDTFA made an allowance for appellant's start-up at the new location by dividing audited sales of $215,775 for 4Q13 by three months to compute an average of monthly sales of $71,925 and only included the average for one month as audited sales for 1Q14. Appellant has not provided documentation to support an additional adjustment to audited taxable sales for 1Q14. Appellant does not provide evidence documenting the alleged extended period of limited sales due to the move to the new location and "soft opening," and buildup of customers, employees, and merchandise, such that a further adjustment should be made.

OTA notes that for 2Q14, CDTFA added the increase in sales of $55,431 ($71,925 × 77 percent) to audited taxable sales of $215,775 from 4Q13 rather than the corresponding 1Q14 audited taxable sales of $71,925. OTA finds that this computation distorts audited taxable sales for 2Q14 since the resulting taxable sales amount of $271,206 ($215,775 + $55,431) represents a growth rate of 277 percent ([$271,206 - $71,925] ÷ $71,925) between 1Q14 and 2Q14 rather than the calculated growth trend of 77 percent. Thus, adjusting for this, OTA computes taxable sales of $127,356 ($71,925 + $55,431) for 2Q14 which will also impact the calculation of audited taxable sales for 3Q14 though 2Q15. Taxable sales for 2Q14 should be computed by adding the increase in sales of $55,431 to the 1Q14 audited taxable sales of $71,925. For each subsequent quarter, the audited growth trends should be applied to the adjusted taxable sales to compute audited taxable sales for 3Q14 though 2Q15. Otherwise, appellant has not shown that further adjustments should be made.

Issue 2: Whether appellant is liable for the negligence penalty.

R&TC section 6484 provides that, if any part of a 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. Negligence is generally defined as a failure to exercise such care that a reasonable and prudent person would exercise under similar circumstances. (*Warner v. Santa Catalina Island Co.* (1955) 44 Cal.2d. 310, 317; see also *People v. Superior Court (Sokolich)* (2016) 248 Cal. App. 4th 434, 447.) In *Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167

Cal.App.2d 318, 323, the court held that a negligence penalty is justified where errors are continued from one audit to the next.

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 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 or intent to evade the tax. (Cal. Code Regs., tit. 18, § 1698(k).)

CDTFA imposed a negligence penalty pursuant to R&TC section 6484 because the amount of the understatement was large, books and records provided were inadequate for sales and use tax audit purposes, and appellant failed to correct errors found in the prior audit. Appellant contends that the basis upon which the understatement was established is erroneous. Appellant asserts it acted in good faith by implementing a POS system in accordance with CDTFA's recommendations in the prior audit and fully cooperated with CDTFA.

OTA notes that unreported taxable sales of $4,534,731 is substantial and this understatement represents an error ratio of 358 percent when compared to reported taxable sales of $1,265,032.[12] Although OTA has found that an adjustment to the liability is warranted, OTA estimates that the measure of unreported taxable sales would still exceed $3,400,000.[13] Thus, the error ratio remains substantial, somewhere near 269 percent. The large error ratio and the substantial understatement amount are evidence of negligence. In addition, the books and records appellant provided were incomplete and inadequate for sales and use tax audit purposes. In particular, appellant did not provide source documents, such as sales invoices, cash register tapes, or any other source documentation for sales. In addition, the new POS system data during that observation test showed that it was not used to record all sales transactions. The failure to maintain and provide adequate books and records is evidence of negligence.

[12] That is, the "error ratio" is the percentage of unreported taxable sales to reported taxable sales.

[13] CDTFA will do the final calculation.

In the prior audit, appellant did not provide adequate books and records, which required CDTFA to estimate appellant's audited taxable sales based on an alternative method. CDTFA agreed to taxable sales of $1,120,633 that appellant computed for the liability period which when compared to appellant's reported taxable sales of $491,974 for the same period is a difference of $628,659 and represented an error ratio of 128 percent. Thus, the errors have continued from one audit to the next which is evidence of negligence. (See *Independent Iron Works, Inc. v. State Bd. of Equalization*, *supra*, 167 Cal.App.2d at p. 323.) For the above reasons, appellant is liable for the negligence penalty.

HOLDINGS

1. Further adjustments to the measure of tax are warranted as explained in Issue 1.
2. Appellant is liable for the negligence penalty.

DISPOSITION

OTA directs CDTFA to reduce the audited taxable sales for 2Q14 from $271,206 to $127,356, and to make any corresponding adjustments to the audited taxable sales for 3Q14 though 2Q15.[14] In all other respects, OTA sustains CDTFA's action and the liability shall otherwise be redetermined pursuant to CDTFA's second reaudit report.

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Josh Lambert
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Josh Lambert
Administrative Law Judge

We concur:

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Andrew J. Kwee
Administrative Law Judge

Date Issued: 1/19/2023

[14] The audited growth trends should be adjusted in these subsequent quarters to reflect the reduction to the 2Q14 liability.