OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	OTA Case No. 21088501
THE VAN NUYS GROUP, LLC, dba The Green Easy	CDTFA Case ID: 1050087

OPINION

Representing the Parties:

For Appellant:	Faith Devine, Attorney
For Respondent:	Jason Parker, Chief of Headquarters Operations
For Office of Tax Appeals:	Richard Zellmer Business Taxes Specialist III

J. ALDRICH, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, The Van Nuys Group, LLC dba The Green Easy (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA),[1] partially denying appellant's petition for redetermination of the Notice of Determination (NOD) dated January 24, 2018.[2] The NOD is for tax of $355,517.12, applicable interest, and a negligence penalty of $35,551.71, for the period October 1, 2012, through September 30, 2015 (audit period).

In its decision, CDTFA reduced the understated taxable measure from $3,961,210 to $3,113,360 and denied the remainder of the petitioned amount. This will result in corresponding reductions to the tax, interest, and penalty.

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

[2] CDTFA timely issued the NOD because appellant waived the otherwise applicable three-year statute of limitations by signing a series of waivers, the last of which gave CDTFA until January 31, 2018, to issue the NOD for the period October 1, 2012, through September 30, 2015. (R&TC, §§ 6487(a), 6488.)

Appellant waived the right to an oral hearing; therefore, the matter is being decided based on the written record.

ISSUES

1. Whether appellant has shown that any further reduction to the measure of unreported taxable sales is warranted.
2. Whether appellant was negligent.

FACTUAL FINDINGS

1. Appellant operated a retail medical cannabis dispensary in a high traffic area of Los Angeles, California. Appellant sold cannabis products and related paraphernalia. During the period January 1, 2014, through June 30, 2014, appellant was in the process of moving into a new location a few blocks away from the original location, and during that period appellant made limited delivery sales but did not operate out of a storefront. Appellant was not fully operational between July 1, 2014, and August 13, 2014.
2. For the audit period,[3] appellant reported total sales and taxable sales of $590,965, claiming no deductions.
3. For audit, appellant provided CDTFA with the following: federal income tax returns (FITRs) for 2012, 2013, and 2014; bank statements and sales summaries for the audit period; a summary of sales tickets for the third quarter of 2015 (3Q15); sales tickets for July 1, 2015; and video footage of the operations inside the business on February 16, 2016.[4]
4. CDTFA examined the available records as follows:
   a. CDTFA noted that gross receipts reported on appellant's FITRs for 2012, 2013, and 2014 reconciled to total sales reported on the sales and use tax returns for the same years, with no differences. However, CDTFA noted that there was no cost of goods sold reported on the FITRs. Since no costs of goods sold were reported, CDTFA was

[3] During the audit period, cannabis was not legal for recreational use in this state. The recreational use of cannabis became legal in California when the voters in this state passed Proposition 64, also known as the Adult Use of Marijuana Act, on November 8, 2016.

[4] CDTFA asserts that the video footage consists of 65 separate video clips taken at intermittent times on February 16, 2016, from 1:00 p.m. to 7:50 p.m., but excluded the period 2:10 p.m. to 4:13 p.m.

unable to examine appellant's markup. Thus, CDTFA considered the FITRs to be incomplete.

b. CDTFA also noted that bank deposits exceeded total sales reported on the sales and use tax returns by $78,319 for the audit period. Appellant explained that this difference was due to an owner's contribution to the business, but at the time, appellant provided no documentation to support the owner contribution. CDTFA also opined that many of appellant's customers would pay with cash, and there was no way to know whether all cash proceeds from sales were deposited into the business bank account. CDTFA concluded that the bank deposits did not provide a reliable source of sales.

c. CDTFA used the summary of sales tickets for 3Q15 to compute $27.61 as the amount of an average sale, which was far less than the $50 per sale average that CDTFA expected based on its experience in auditing similar businesses in appellant's area. CDTFA noted that the summary of sales tickets appellant provided for 3Q15 listed 31 sales on July 1, 2015, but appellant provided only 19 sales tickets for that day. CDTFA also examined appellant's 3Q15 records to calculate an average of 34 customers per day or 3.4 customers per hour based on the 10-hour business day, which CDTFA considered to be low. CDTFA concluded that the sales tickets provided by appellant were incomplete based on the discrepancy.

Based on the foregoing, CDTFA found that appellant's books and records could not be used to determine appellant's sales, and CDTFA decided to use an observation test to determine appellant's sales.

5. CDTFA attempted to schedule an observation test inside of appellant's store, but appellant refused, citing the privacy of its customers. Therefore, CDTFA decided to observe the business from outside the store. CDTFA observed the business from outside on Thursday, January 28, 2016, for four hours (10:00 a.m. to 12:00 p.m. and 1:00 p.m. to 3:00 p.m.) and observed 28 customers enter the store during those hours. CDTFA observed the business from outside on Tuesday, February 9, 2016, for four hours (10:00 a.m. to 12:00 p.m. and 1:00 p.m. to 3:00 p.m.) and observed 51 customers enter the store during those hours. CDTFA observed the business from outside on Wednesday, February 10, 2016, for four hours (1:00 p.m. to 5:00 p.m.) and observed 57 customers

enter the store during those hours. CDTFA observed the business from outside on Monday, February 22, 2016, for four hours (11:00 a.m. to 1:00 p.m. and 2:00 p.m. to 4:00 p.m.) and observed 30 customers enter the store during those hours. In total, CDTFA observed the business for 16 hours and observed 166 customers enter the store. CDTFA computed an average of 10 customers per hour (166 ÷ 16).

6. During the audit period, appellant's business was open 10 hours each day. CDTFA calculated 100 customers per day (10 customers per hour x 10 hours). Based on its experience in auditing similar businesses in appellant's area, CDTFA established an average selling price of $50 per customer. CDTFA computed average taxable sales of $5,000 per day ($50 x 100 customers). CDTFA multiplied sales of $5,000 per day by 91 days to compute audited taxable sales of $455,000 per quarter.
7. CDTFA accepted reported taxable sales for 1Q14 and 2Q14 because appellant did not operate out of a storefront during the majority of those two quarterly periods. For the remaining 10 quarterly reporting periods in the audit, reported taxable sales totaled $588,790. CDTFA calculated audited taxable sales for those 10 quarterly periods of $4,550,000 (quarterly sales of $455,000 x 10). CDTFA computed unreported taxable sales of $3,961,210 for the original audit ($4,550,000 - $588,790).
8. CDTFA issued the NOD to appellant on January 24, 2018, based on unreported taxable sales of $3,961,210.
9. Appellant filed a timely petition for redetermination of the NOD.
10. CDTFA held an appeals conference with appellant on May 19, 2020. After the appeals conference, appellant provided sales tickets for the observation test days of January 28, 2016, February 9, 2016, February 10, 2016, and February 20, 2016 (all after the audit period); and a menu listing the products appellant sold.
11. In its Decision issued on January 27, 2021, CDTFA decided that the number of customers should be reduced by 5 percent to account for customers who entered the business but did not make a purchase. Also, CDTFA decided to reduce the average selling price to $45 per customer. Finally, CDTFA conceded that appellant was not fully operational during the 44-day period July 1, 2014, through August 13, 2014, due to moving and remodeling the new location. CDTFA thus recommends deleting that 44-day period from the audit results. As a result, CDTFA ordered that a reaudit be done to make the following

adjustments: 1) reduce the number of customers per hour by 5 percent, from 10 to 9.5; 2) reduce the average selling price from $50 to $45; 3) and delete 44 days in 3Q14 from the measure of tax to account for appellant being closed.

12. CDTFA prepared a reaudit in accordance with the instructions of the Decision. In the reaudit, CDTFA calculated 95 customers per day (9.5 customers per hour x 10 hours). CDTFA then computed average taxable sales of $4,275 per day ($45 per customer x 95 customers). CDTFA multiplied taxable sales of $4,275 per day by 91 days to compute audited taxable sales of $389,025 per quarter. For 3Q14, CDTFA subtracted 44 days from 91 days to compute 47 days the business was open. CDTFA then multiplied 47 days by $4,275, per day, to compute audited taxable sales of $200,925 for 3Q14. CDTFA again accepted reported taxable sales for 1Q14 and 2Q14. For the other 10 quarterly periods in the audit, CDTFA computed audited taxable sales of $3,702,150 (($389,025 x 9 quarters) + ($200,925)). Upon comparison to reported taxable sales for those same 10 quarterly periods, CDTFA computed unreported taxable sales of $3,113,360 in the reaudit.
13. Appellant timely appealed to the Office of Tax Appeals (OTA).
14. On appeal to OTA, appellant provided additional sales tickets for July 2015.

DISCUSSION

Issue 1: Whether appellant has shown that any further reduction to the 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, §§ 6012, 6051.) For purposes 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 requests 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).)

If 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.) 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.) The applicable burden of proof is by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(b); *Appeal of Estate of Gillespie*, 2018-OTA-052P.)

Appellant did not provide sufficient records to CDTFA to support the accuracy of its reported taxable sales, particularly information to support purchases or costs of goods sold, which means that CDTFA was unable to review appellant's book markups. In addition, appellant did not provide complete sales journals or sales invoices. Regarding the invoices provided, CDTFA noted that the invoices appellant provided for July 1, 2015, were incomplete. Further, CDTFA considered the average number of 3.4 sales per hour to be low when compared to the hours of operation and appellant's location. Based on these concerns, CDTFA's decision to compute appellant's taxable sales with an observation test,[5] an indirect audit methodology, was reasonable and rational.

Furthermore, CDTFA is not required to accept as conclusive evidence the taxpayer's books and records, even though these were in agreement with each other, where CDTFA, using recognized and standard accounting procedures, established in an audit that the books and records did not disclose the correct amount of tax liability. (*Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 615 (*Riley B's*).)[6] Since appellant would not allow CDTFA to perform an observation from inside of the business, OTA finds that it was reasonable

[5] An observation test is a standard and accepted audit procedure. (See *Riley B's*, *supra*, 61 Cal.App.3d p. 615.)

[6] The court held that "[R&TC sections 6481 and 7054] . . . clearly contemplate an examination 'behind the books,' so to speak, in which original records, such as purchase invoices, sales slips, cash register tapes, and inventory records may be audited and analyzed. There is no requirement that such audit be restricted to pointing out falsifications, errors or omissions, if any, in the books of account themselves." (*Riley B's*, *supra*, 61 Cal.App.3d p. 615.)

and rational for CDTFA to conduct the test by observing from outside the business and counting the number of individuals who entered the business. The 16 hours of observation were conducted over a 25-day period on a Thursday, Tuesday, Wednesday, and a Monday. Absent evidence to the contrary, OTA finds that it was reasonable and rational for CDTFA to conclude that 5 percent of the individuals who entered the business did not make a purchase from appellant since some patrons may have entered the dispensary with a partner, or in a group, and since retail sales of recreational cannabis were not yet legal there would likely be fewer window-shoppers than after recreational cannabis became legal in California. OTA also finds that it was reasonable for CDTFA to establish the average selling price at $45 based on its experience in auditing similar businesses in appellant's area together with appellant's menu prices. Thus, OTA finds that CDTFA has met its initial burden to show that its determination was reasonable and rational. Therefore, the burden of proof shifts to appellant to show errors in the audit.

Observation Test

Appellant contends CDTFA's use of the observation test method was not justified because CDTFA failed to conduct a proper analysis of the sufficiency of appellant's records. Appellant contends that CDTFA erred in finding that appellant's books and records were inadequate. Appellant asserts that the lack of cost of goods sold amounts on the FITRs is due to government ordinances that prohibit medical cannabis dispensaries from purchasing products for resale. Therefore, the lack of cost of goods sold amounts on the FITRs should not have caused CDTFA to disregard the FITRs. Appellant asserts that CDTFA should not have disregarded the bank statements because the difference in bank deposits is due to owner contributions. Appellant asserts that it maintained all source documents for the audit period, but the auditor only asked for the sales tickets for July 1, 2015. Appellant alleges that the sales tickets it provided for July 1, 2015, match the relevant information from the summary of sales tickets for 3Q15. Appellant has also provided the sales tickets for July 1, 2015, and the summary of sales tickets for 3Q15. For all of these reasons, appellant argues that CDTFA should not have used an observation test to establish appellant's sales.

As previously noted, CDTFA does not need to find errors or omissions in the books and records before utilizing standard and accepted audit procedures to verify the accuracy of reported sales. (*Riley B's*, *supra*, 61 Cal.App.3d p. 615.) CDTFA may choose to perform audit tests to verify the accuracy of a taxpayer's books and records without a preliminary showing of errors or

omissions in those books and records. (R&TC, § 6481.) R&TC section 6481 contains no prerequisite that CDTFA find a specific fault with a taxpayer's records before making a determination of taxable sales. Thus, OTA finds appellant's arguments regarding the use of an observation test unpersuasive.

Appellant argues the observation test was unreliable because it was conducted at a time period that was not representative of appellant's business activity during the audit period. Appellant has not provided documentary evidence to show that the observation test is not representative of its business activity during the audit period; therefore, OTA finds this contention unconvincing.

Purchases per hour

Appellant contends that CDTFA's assumption that 95 percent of the customers made a purchase is unreliable. Appellant asserts the observation test relied on video footage that BTFD misplaced, and did not preserve for appeal.

Appellant provided CDTFA with video footage of the inside of appellant's business on February 16, 2016. CDTFA asserts that the video footage shows 46 customers entering the store, and 45 of those 46 customers made a purchase. CDTFA argues that the video footage supports its position that 95 percent of the customers who entered the store made a purchase. However, CDTFA argues that since the video footage did not account for the entire business day, the video footage was not representative of the number of customers who made a purchase from appellant each day. Appellant alleges that CDTFA edited the video footage. It is not in the evidentiary record before OTA. CDTFA contends that it has lost the video footage.

The fact that the video footage is now unavailable does not form a basis for OTA to conclude that less than 95 percent of the persons entering the business made a purchase from appellant. Appellant has not provided evidence (e.g., other video footage) to show that the percentage of individuals entering the business who made a purchase was less than 95 percent. Therefore, OTA finds that no adjustment is warranted for this argument.

Average selling price

Appellant contends that the average $45 selling price is unsupported by credible evidence, and is contradicted by appellant's own sales tickets for July 1, 2015, which show an average selling price of $27. Appellant asserts that the sales tickets for July 1, 2015 are

complete. Appellant also asserts that since the selling prices from the sales tickets for July 1, 2015, match the selling prices listed on its menus, then appellant's asserted $27 average selling price should be accepted. With its supplemental opening brief, appellant has provided copies of the relevant menus and additional sales tickets from July 1, 2015.

Regarding the 31 sales tickets appellant provided for July 1, 2015, OTA notes that 12 of them are consecutively numbered from 151 to 162, and the remaining 19 are numbered from 651 to 670. Thus, there were at least two separate invoice sequences utilized by appellant on that date. There are also significant gaps in these invoice sequences. For example, for the next day, July 2, 2015, appellant provided sales tickets that are numbered from 701 to 720. OTA has no way to know how many different invoice sequences appellant used on any given day, or whether appellant has fully accounted for all of the sales tickets in any given sequence. Appellant has not accounted for the sales tickets numbered prior to 151, or the sales tickets from 163 to 650, or the sales tickets from 671 to 700. Consequently, OTA finds that the evidence is insufficient to conclude that appellant has provided all of its sales tickets from July 1, 2015. When the 31 sales tickets submitted for July 1, 2015, are compared to the number of sales tickets that appellant submitted for the observation test days, OTA notes that 31 tickets is approximately half as many tickets as the available observation test day tickets, which ranged from 59 to 78 sales tickets. Furthermore, the evidence is insufficient to conclude that those 31 sales tickets are representative of appellant's average selling price. Therefore, OTA finds that the sales tickets appellant provided are insufficient to support a reduction to the audited average selling price of $45.

There are three different menus in evidence. One is a menu CDTFA obtained from Google Maps that lists appellant's selling prices in effect in 2016. One is a menu provided by appellant that lists appellant's selling prices in effect in August 2014. Appellant alleges that it increased its selling prices in January 2016, and the menu it has provided for August 2014 reflects the selling prices in effect during the audit period October 1, 2012, through September 30, 2015. The third is a menu CDTFA obtained on the internet from the Wayback Machine[7] that lists appellant's selling prices in effect on September 29, 2014.

The menu obtained by CDTFA from Google maps shows several different prices for each "flower" product.[8] For example, the selling prices for the product "Tangerine OG" are listed as

[7] The Wayback Machine is a website that can be used to obtain historical webpages from various websites.

[8] A "flower" product is typically the consumable part of the cannabis plant.

follows "$20 - $55 - $110 - $170 - $325." OTA makes the inference that the different selling prices are for different quantities of the product, but the menu does not state what those quantities are. However, one gram and 3.5 grams are common quantities of flower products sold at cannabis stores. (See *Appeal of AMG Care Collective, supra*.) Therefore, OTA logically infers that the first price is the price for 1 gram, the second price is the price for 3.5 grams, the third price is the price for a quarter of an ounce, the fourth is the price for a half of an ounce, and the fifth price is the price for an ounce.

The menu appellant provided that is allegedly from August 2014 lists two selling prices for each flower product. For example, the selling prices for the product "Blue Dream" are listed as follows "$10/$30." Again, the menu does not state the quantities applicable to each price, but OTA infers that the first price is the price for 1 gram, and the second price is the price for 3.5 grams. Appellant's menu also lists various selling prices for other products, such as edibles, "prerolls," concentrates, etc. ranging from $3 to $30.

The copy of the menu that CDTFA obtained from the Wayback Machine also lists several selling prices for each flower product. However, the copy of the menu submitted to OTA is cropped off on the left side such that the selling prices for 1 gram have been cut off. However, appellant acknowledges that the menu it provided and the menu obtained by CDTFA from the Wayback Machine were in existence at the same time. Appellant indicates that the menu obtained by CDTFA from the Wayback Machine is more detailed than the menu appellant provided. Nonetheless, appellant asserts that the Wayback Machine menu should be disregarded because it had not been updated to reflect changes in appellant's selling prices.

Most of the flower products listed in the Wayback machine menu are not listed on the menu appellant provided, but a few of the products appear on both menus. CDTFA asserts that for products listed on both of those menus, the selling price listed on the Wayback Machine menu are greater than the prices listed on the menu appellant provided. For example, CDTFA asserts that the selling price of 1 gram of "Blue Dream" is $10 higher on the Wayback Machine menu than the menu furnished by appellant, and the selling price of 3.5 grams of "Blue Dream" is $25 higher on the Wayback Machine menu than the menu furnished by appellant. Many of the selling prices listed on the Wayback Machine menu for 3.5 grams exceed $45. OTA is not persuaded by appellant's unsupported claim that the Wayback Machine menu had not been

updated to reflect changes in appellant's selling prices. Here, there is sufficient doubt as to when the selling prices on each of these two menus were in effect.

Some of the sales tickets for July 1, 2015, list selling prices that are also listed on the menu furnished by appellant. However, sales ticket 0160 lists a selling price of $20 for Pearl OG, which is the selling price listed on the first menu provided by CDTFA from Google Maps for 1 gram of that product. Further, the product Pearl OG is not listed in the menu furnished by appellant. Thus, OTA finds that the menu appellant provided is incomplete.

In addition, the information in the record is insufficient to determine the average quantity per sale of flower products appellant sold; having the prices from the menus without the average quantity purchased leaves OTA with no way to calculate an average price per sale. For all of the above reasons, OTA finds that the evidence furnished by appellant is insufficient to show that appellant's average selling price was less than $45.

Audit Procedures

Appellant contends that CDTFA did not perform the observation test in accordance with section 0810.30 of the CDTFA Audit Manual. Regarding the observation test appellant makes the following arguments: first, the auditor failed to prepare an Observation Test Fact Sheet as required in section 0810.30 of the CDTFA Audit Manual; second, in order to be used for projection purposes, the observation test must include three full days; and third, the auditor must schedule the sales as they are rung on the register. Appellant notes that CDTFA did not offer to expand the test to three full days until December 13, 2016, which almost one year after the observation tests were performed, and appellant declined that offer because appellant believed that a test during or after December 2016 would not be representative of the sales made during the audit period. Finally, appellant argues that CDTFA failed to follow proper exit procedure guidelines as provided in its Audit Manual.

OTA notes that CDTFA's Audit Manual does not provide binding legal authority; however, OTA may look to it for guidance. (*Appeal of Micelle Laboratories, Inc.*, 2020-OTA-290P.) At the time the audit was conducted, CDTFA did not have established audit manual procedures for medical cannabis dispensaries. By analogy, CDTFA modeled observation tests for cannabis businesses after test procedures for a bar or restaurant. Also, during this time, CDTFA deemed two days to be a sufficient test for a bar or restaurant. CDTFA's procedures, however, were revised in January of 2017. The Audit Manual language

regarding observation testing is in Chapter 8, entitled "Bars and Restaurants." (https://www.cdtfa.ca.gov/taxes-and-fees/staxmanuals.htm.)

Appellant has not shown how the failure to prepare an Observation Test Fact Sheet, or to record sales as they were rung on the register, or to test three full days, caused the observation test to be inaccurate or unreliable. Appellant has not shown how the alleged failure to follow proper exit procedure guidelines caused the audit result to be inaccurate or unreliable. OTA, therefore, finds that no adjustment is warranted for this contention.

Although the above is dispositive on this issue, OTA notes that since appellant refused to allow CDTFA to perform its observations from inside the business, appellant made it impossible for CDTFA to record sales as they were rung on the register. Also, as appellant acknowledged, CDTFA did offer to expand the observation test to include three full days, but appellant declined the offer because appellant believed the expanded test would be conducted too far beyond the audit period to be representative. Moreover, in a different appeal involving a medical cannabis dispensary that failed to maintain or provide adequate records, OTA previously concluded that a three-factor[9] approach, similar to the approach in this appeal, was reasonable. (*Appeal of AMG Care Collective, supra*.)

Appellant contends that, if the observation test is to be used, OTA should accept appellant's calculation of the understatement, which was previously given to CDTFA, and results in unreported taxable sales of $636,189. In its calculations, appellant starts with 100 persons entering the store each day, then reduces that amount to 55 purchasing customers each day (appellant assumes that 45 percent of the persons who entered the store did not make a purchase). Appellant then multiplies 55 purchasing customers by appellant's average of $27 per purchase to compute $1,485 in sales per day. Appellant multiplied that amount by 91 to compute $135,135 of sales per quarter, which appellant applies to each quarter of the audit period (except 1Q14, 2Q14 and 3Q14, when appellant was moving and remodeling). In total, appellant computes audited taxable sales of $1,227,154, which was compared to reported taxable sales to compute unreported taxable sales of $636,189.

[9] The three-factor approach included: (1) an estimated average purchase amount per patron based on CDTFA's experience with comparable businesses; (2) an estimated number of patrons per hour based on CDTFA's observations of the appellant's business; and (3) the number of hours the business operated based on information provided to, or obtained by, CDTFA.

OTA finds appellant's calculations unpersuasive primarily because appellant has not provided support that only 55 percent of the persons entering its store made a purchase. Also, OTA finds that the evidence provided by appellant is insufficient to support a selling price of $27 per purchase.

Based on the above finding that appellant has failed to provide any documentation or other evidence from which a more accurate determination could be made, OTA concludes that appellant has failed to meet its burden of establishing that a reduction to the measure of unreported taxable sales is warranted.

Issue 2: Whether appellant was negligent.

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.)

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 states that it imposed the negligence penalty provided by R&TC section 6484 because: 1) appellant's books and records were inadequate, and 2) the understatement of tax is substantial.

California Code of Regulations, title 18, section 1703 provides in subdivision (c)(3)(A) that a negligence penalty should not be added to a deficiency determination 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. (See also *Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 321-324.) Appellant had not been previously audited.

CDTFA states that it imposed the negligence penalty provided by R&TC section 6484 because: 1) appellant's books and records were inadequate, and 2) the understatement of tax is substantial.

Appellant argues that CDTFA based its imposition of a negligence penalty on the incorrect assumption that appellant's records were not adequate. Appellant contends that CDTFA erroneously based the negligence penalty on the incorrect assumption that appellant's sales tickets for July 1, 2015, did not match its sales summaries. Appellant argues that the negligence penalty is not warranted in this case since it was appellant's first audit, and it produced all records that were requested by the CDTFA auditors. Finally, appellant asserts that at an exit conference on December 2, 2016, CDTFA stated that it would not impose the negligence penalty.

Here, OTA found appellant's records to be inadequate as discussed above. Appellant did not provide any record of merchandise purchases. Appellant also did not provide a complete set of sales tickets. OTA finds that the lack of books and records is evidence of negligence.

The understatement of $3,113,360 represents an error ratio of 527 percent when compared to reported taxable sales of $590,965 ($3,113,360 ÷ $590,965). Thus, appellant reported only about one out of every six sales.[10] In this case, failing to report five out of six sales cannot be attributed to appellant's 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. (See also *Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 321-324.) Thus, OTA finds that the understatement is due to negligence.

Finally, the fact that CDTFA may have rescinded its initial decision to not impose the negligence penalty does not form a basis for OTA to delete the penalty. (See R&TC, § 6563(a).)

[10] Unreported taxable sales of $3,113,360 + reported taxable sales of $590,965 = audited taxable sales of $3,704,325. Audited taxable sales of $3,704,325 ÷ reported taxable sales of $590,965 = 6.26.

HOLDINGS

1. Appellant has not shown that reductions to the measure of tax are warranted.
2. The negligence penalty was properly imposed.

DISPOSITION

Respondent's action in reducing the taxable measure to $3,113,360, and otherwise denying the petition, is sustained.

DocuSigned by:
Josh Aldrich
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Josh Aldrich
Administrative Law Judge

We concur:

DocuSigned by:
Natasha Ralston
25F8FE08FF56478...
Natasha Ralston
Administrative Law Judge

DocuSigned by:
3CADA62FB4864CB...
Andrew J. Kwee
Administrative Law Judge

Date Issued: 11/13/2023