OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **M.K. KAKISH AND** **M.H. KAKISH,** **dba Up in Smoke – Smoke Shop**	OTA Case No.: 240817131 CDTFA Case ID: 3-037-065

OPINION

Representing the Parties:

For Appellant: Carlos Gomez, Attorney

For Respondent: Jason Parker, Chief of Headquarters Ops.

For Office of Tax Appeals: Crystal Spratley, Business Taxes Specialist

A. WONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561 and California Code of Regulations, title 18, (Regulation) section 30103(b), the partnership of M.K. Kakish and M.H. Kakish (appellant) appeals a decision and supplemental decision issued by respondent California Department of Tax and Fee Administration (CDTFA).[1] CDTFA's decisions partly denied appellant's administrative protest of a Notice of Determination (NOD) issued by CDTFA on July 17, 2019. The NOD was for tax of $139,825, plus applicable interest, and a 10 percent negligence penalty of $13,982.52, for the period January 1, 2015, through September 30, 2018 (liability period).[2] As relevant here, the tax is based in part on unreported taxable sales of $1,666,606.

[1] The State Board of Equalization (BOE) formerly administered sales and use taxes. On July 1, 2017, BOE administrative functions relevant to this case transferred to CDTFA. (Gov. Code, § 15570.22.) For ease of reference, when this Opinion refers to events that occurred before July 1, 2017, "CDTFA" shall refer to the BOE.

[2] CDTFA timely issued the NOD because appellant waived the otherwise applicable three-year statute of limitations and gave CDTFA until October 31, 2019, to issue the NOD. (See R&TC, §§ 6487(a), 6488.) After issuing the NOD, CDTFA added the following to appellant's liability: a "finality penalty" because appellant failed to pay the NOD before it became final (i.e., due and payable); and a collection cost recovery fee (CCRF) because the NOD remained unpaid for more than 90 days. (See R&TC, §§ 6565, 6833.) However, CDTFA's supplemental decision conditionally relieved appellant of the finality penalty and unconditionally relieved it of the CCRF. Accordingly, the finality penalty and the CCRF are not at issue in this appeal.

Appellant waived the right to an oral hearing; therefore, the matter was submitted to the Office of Tax Appeals (OTA) for an opinion based on the written record pursuant to Regulation section 30209(a).

ISSUES

1. Whether the amount of unreported taxable sales should be reduced.
2. Whether appellant was negligent.

FACTUAL FINDINGS

1. Appellant, a partnership doing business as Up In Smoke – Smoke Shop, operated in Costa Mesa, a city in Orange County, California. The smoke shop sold cigarettes, hookahs, vapes, small pipes, and miscellaneous taxable items; the shop also sold drinks, including soda, energy drinks, juice, and water.
2. CDTFA issued appellant a seller's permit effective from January 12, 2011, through August 31, 2018, when appellant incorporated its business.
3. For the liability period, appellant claimed no deductions and reported total and taxable sales of $3,780,899 on its sales and use tax returns (SUTRs).
4. As relevant here, one of appellant's partners (M.K. Kakish) concurrently operated another smoke shop as a sole proprietor under a separate sellers' permit account. This smoke shop was in Upland, a city in San Bernardino County, California. According to an email in the record, the Upland smoke shop had been in operation for 10 years before appellant opened its smoke shop in Costa Mesa. CDTFA audited the Upland business, which also did business as Up In Smoke – Smoke Shop, for the period April 1, 2014, through June 30, 2016, and determined there was a deficiency. On March 2, 2017, CDTFA issued an NOD to appellant's partner for this deficiency.

CDTFA's Audit

5. CDTFA first contacted appellant about this audit on January 26, 2018.
6. Upon audit, appellant provided the following books and records: federal income tax returns (FITRs) for 2015, 2016, and 2017; SUTR worksheets for 2015, 2016, and 2017; bank statements for 2015, 2016, and 2017; point-of-sale (POS) system reports for the fourth quarter of 2016 (4Q16) through 1Q17; four sales receipts from the month of August 2018; a purchase journal for 2016; and purchase invoices for April 2018.

Additionally, CDTFA obtained merchandise purchase information from one of appellant's vendors, Sam's Club, for 2015, 2016, and 2017, and Form 1099-K data for 2016.[3] Appellant did not provide the following books and records: sales receipts and purchase invoices for most of the liability period; and POS z-tapes for all of the liability period.[4]

7. As a preliminary matter, CDTFA compared gross receipts appellant reported on FITRs with taxable sales reported on SUTRs for 2015, 2016, and 2017 and calculated differences of -$6,395, $0, and $104,065, respectively. Because reported gross receipts exceeded reported taxable sales by $104,065 for 2017, CDTFA found that this was evidence of unreported taxable sales.

8. Additionally, CDTFA compared gross receipts to the cost of goods sold (COGS), both of which appellant reported on FITRs for 2015, 2016, and 2017. CDTFA calculated book markups of 31.01 percent for 2015, 34.59 percent for 2016, 16.84 percent for 2017, and 24.80 percent overall.[5] CDTFA found these book markups to be inconsistent and lower than its expected markup of 100 percent.[6]

9. Further, CDTFA compared bank deposits recorded on the bank statements for 2015, 2016, and 2017 to taxable sales reported on the SUTRs for corresponding periods. CDTFA found that appellant reported more taxable sales for each quarter in the liability period than deposits appellant made into its bank for the corresponding quarter, and that appellant deposited minimal cash. Accordingly, CDTFA concluded that it could not verify appellant's sales using bank deposits.

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[3] Form 1099-K is an Internal Revenue Service form titled "Payment Card and Third-Party Network Transactions," which shows the monthly and annual amounts paid to a merchant by a bank, credit card company, or third-party payment network, during a given time period. Form 1099-K includes payments made by any electronic means, including, but not limited to, credit cards, debit cards, and PayPal.

[4] A z-tape is the portion of a POS system's tape that summarizes sales by category for a certain time period (e.g., a day or a shift).

[5] "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 $0.70 and it charges customers $1.00, the markup is $0.30. The formula for determining the markup percentage is markup amount divided by cost. In this example, the markup percentage is 42.86 percent (0.30 ÷ 0.70 = 0.42857). A "book markup" is one that is calculated from the retailer's records. Markup and gross profit margin are different. The gross profit is the sales price minus the cost. The formula for determining the gross profit margin is profit amount ÷ sales price. In the above example, the gross profit margin is 30 percent (0.30 ÷ 1.00 = 0.30).

[6] Later, during CDTFA's internal appeals process, the Appeals Bureau determined that CDTFA should have compared COGS reported on the FITRs to total sales reported on the SUTRs, which would have resulted in book markups of 32.29 percent for 2015 (versus 31.01 percent), 34.59 for 2016 (no difference), and 8.05 percent for 2017 (versus 16.84 percent). The Appeals Bureau concluded that these corrected book markups likely would not have changed CDTFA's decision to perform additional testing.

10. Based on this preliminary examination, CDTFA concluded that it could not use appellant's FITRs, SUTRs, or bank statements for 2015, 2016, and 2017 to verify appellant's reported taxable sales directly. Instead, CDTFA turned to an indirect audit method: the markup method, which entails applying a markup to the cost of taxable goods sold.

11. To calculate an audited weighted taxable markup, CDTFA used appellant's purchase journal for 2016 and merchandise purchase information from Sam's Club for that same year to complete a purchase segregation test.[7] CDTFA then used the purchase invoices from April 2018 and POS system sale prices orally obtained from appellant on July 12, 2018, to perform a shelf test.[8] Combining the results of the purchase segregation test and the shelf test, CDTFA computed an audited weighted taxable markup of 102.24 percent.

12. Next, CDTFA calculated the audited cost of taxable goods sold to which it would add the markup. To this end, CDTFA reduced total COGS of $2,327,046 reported on appellant's FITRs for 2015, 2016, and 2017 by the following: (a) purchases of nontaxable items ($6,213); (b) purchases of self-consumed items ($4,296); and a 4 percent allowance for purchases that were pilfered/expired/transferred/broken (a.k.a., "shrinkage") ($92,661). Thus, CDTFA computed the audited cost of taxable good sold of $2,223,876 for 2015, 2016, and 2017.

13. CDTFA added the audited weighted taxable markup of 102.24 percent to the audited cost of taxable goods sold of $2,223,876 and computed audited taxable sales of $4,497,488 for 2015, 2016, and 2017. From that amount, CDTFA subtracted a 7.75 percent audited sales discount of $348,555 and reported taxable sales of $2,900,788, computing unreported taxable sales of $1,248,145 (rounded) for those three years.[9]

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[7] A purchase segregation test segregates total merchandise purchases based on product category (e.g., beer, wine, carbonated beverages, tobacco products, "other" taxable merchandise, food, etc.) and/or taxability (i.e., whether a product's sale is subject to taxation or not).

[8] A shelf test compares known costs and associated sale prices to compute markups.

[9] CDTFA allowed a sales discount of 7.75 percent based on appellant's assertion that it gave discounts to customers who provided positive comments about its business on the internet. To calculate the discount of 7.75 percent, CDTFA used the POS system reports for 4Q16 through 4Q17. CDTFA compiled recorded sales of $1,664,099 (excluding returns and discounts) and recorded sales discounts of $139,792 to compute the audited sales discount of 7.75 percent (recorded sales discounts of $139,792 ÷ [recorded sales discounts of $139,792 + recorded sales of $1,664,099]).

14. CDTFA then calculated the following quarterly unreported taxable sales amounts for 2015, 2016, and 2017: $57,875 for 2015; $69,874 for 2016; and $184,288 for 2017. CDTFA also calculated the following percentages of error (POEs): 35.23 percent for 2015; 32.16 percent for 2016; 53.63 percent for 2017; and an overall POE of 43.03 percent.
15. CDTFA applied the overall POE of 43.03 percent to recorded taxable sales for 1Q18, 2Q18, and 3Q18, computing unreported taxable sales of $418,458 for those three quarters.
16. Thus, CDTFA computed unreported taxable sales of $1,666,606 (rounded) ($1,248,145 + $418,458) for the liability period.
17. After determining that appellant failed to maintain adequate books and records or accurately report its taxable sales for the liability period, CDTFA added a 10 percent negligence penalty to the liability. Specifically, CDTFA found that appellant failed to keep and provide sales receipts and purchase invoices for most of the liability period, as well as POS z-tapes for the entire liability period. CDTFA also noted that its audit disclosed an underreporting ratio of 43.03 percent (i.e., the overall POE).
18. As relevant here, on January 22, 2019, appellant's authorized representative informed CDTFA that she had cancer and had been extremely sick since November 2018.
19. On July 16, 2019, CDTFA issued the NOD to appellant.

CDTFA's Internal Appeals Process

20. On August 18, 2021, appellant filed a late appeal, which CDTFA accepted as an administrative protest pursuant to Regulation section 35019.
21. On April 5, 2023, CDTFA's Appeals Bureau held an appeals conference with the parties. Afterwards, it allowed the parties to provide post-conference submissions.
22. In a submission dated April 19, 2023, appellant provided a report summarizing its sales and gross profit margins (gross profit margin summary report) for the period 4Q16 through 3Q18. Appellant argued that the gross profit margin summary report was a more accurate source for computing taxable sales because the gross profit margins recorded therein were more consistent than the various audited product markups that CDTFA determined via its shelf test.
23. In a submission dated May 17, 2023, appellant also contended that a markup of 40.86 percent, which CDTFA had determined via a shelf test in the audit of the Upland smoke shop operated by one of appellant's partners, was more consistent with the

actual markup of appellant's Costa Mesa smoke shop than the audited weighted taxable shelf test markup of 102.24 percent.

24. In a response dated May 31, 2023, CDTFA noted differences between its audit of appellant and its audit of the related Upland smoke shop: "[Appellant's] audit contained over 500 distinct invoices and over 20 distinct vendors for one month. In comparison, the audit of the related entity contained only two invoices for two days and only one distinct vendor." CDTFA also argued to the Appeals Bureau that Costa Mesa was more affluent than Upland, which translated into higher sale prices and markups for appellant.

25. On September 5, 2023, the Appeals Bureau issued a decision denying appellant's protest.

26. Regarding the Upland smoke shop's audited markup of 40.86, the Appeals Bureau's decision first described one of CDTFA's arguments against it: "[CDTFA notes] the business location for the related account was smaller and the area is less affluent." In its analysis, the Appeals Bureau ultimately found that the audited markup of 40.86 percent was based on fewer purchase invoices than the audited weighted taxable markup of 102.24 percent, and the Upland smoke shop differed from appellant's smoke shop in size and general location (specifically, the smoke shops were "not…located in the same general vicinity").

27. Regarding the gross profit margin summary report for 4Q16 through 3Q18, the Appeals Bureau concluded that its data did not justify adjustments to the audited liability for two reasons. First, the markup method utilizes markups not gross profits, which are different.[10] Second, even though the taxable sales recorded on the gross profit margin summary report reconciled with appellant's reported taxable sales for 4Q16 through 3Q18, CDTFA's preliminary examination during the audit had impeached appellant's reported taxable sales, so CDTFA did not accept them as accurate.

28. On November 2, 2023, appellant requested reconsideration. As relevant here, in its request, appellant alleged the following: "Further, as to the markup, we believe that the Appeals Bureau misstated the markup amounts. On the markup papers dated 2/8/19, Taxpayer observes a higher calculated markup for at least some of the audit period."

29. In an email dated December 15, 2023, the Appeals Bureau asked appellant to clarify its argument: "[P]lease clarify where on the audit work papers (referred to as the markup papers) dated 2/8/19, you 'observe a higher calculated markup for at least some of the

[10] *Ante*, fn. 5.

audit period' and where in the Decision was it misstated." The Appeals Bureau also asked appellant about a CDTFA-735 (*Request for Relief from Penalty, Collection Cost Recovery Fee, and/or Interest*) form (request form).

30. In an email response dated December 15, 2023, appellant failed to address the query about its markup argument but answered the question about the request form.

31. On May 15, 2024, the Appeals Bureau issued a supplemental decision, which conditionally relieved appellant of a finality penalty and unconditionally relieved it of a collection cost recovery fee (both not at issue here).[11] Otherwise, the Appeals Bureau continued to deny appellant's administrative protest.

32. Appellant then appealed to OTA.

DISCUSSION

Issue 1: Whether the amount of unreported taxable sales should be reduced.

California imposes upon all retailers a sales tax measured by the 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, it is presumed 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).) If CDTFA is not satisfied with the tax returns or the amount of tax required to be paid to the state by any person, CDTFA may compute and determine the amount required to be paid on the basis of any information within its possession or that 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 Las Playas #10*, 2021-OTA-204P.) If CDTFA's determination is not reasonable and rational, then the determination should be rejected. (*Appeal of Landeros*, 2024-OTA-655P.) If CDTFA's determination is reasonable and rational, then the determination is presumed correct, and the burden of overcoming this presumption is on the taxpayer. (*Ibid*.)

[11] *Ante*, fn. 2.

Generally, the appellant bears the burden of proof as to all issues of fact. (Cal. Code Regs., tit. 18, § 30219(a).) The standard of proof is by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(b).) That is, a taxpayer must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Appeal of AMG Care Collective*, 2020-OTA-173P.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Las Playas #10*, Inc., *supra*.) To satisfy its burden of proof, a taxpayer must prove both that the tax assessment is incorrect and what the proper amount of tax should be. (*Appeal of AMG Care Collective*, *supra*.)

Here, CDTFA's preliminary examination of appellant's FITRs found more gross receipts reported on its FITR for 2017 than taxable sales reported on its SUTRs for that same year, as well as inconsistent and low book markups for 2015, 2016, and 2017. This suggests that appellant underreported its taxable sales. CDTFA's preliminary examination of appellant's bank statements for 2015, 2016, and 2017 found that reported taxable sales exceeded recorded bank deposits for each quarter in the liability period and appellant's cash deposits were minimal. This suggests that appellant's bank statements did not accurately capture or record appellant's sales, especially cash sales. Based on the results of CDTFA's preliminary examination, OTA finds that CDTFA reasonably and rationally concluded that it could not verify appellant's reported sales for the liability period using a direct audit method (i.e., compiling audited sales directly from appellant's records). Instead, CDTFA turned to an indirect audit method: the markup method.

The markup method is a recognized and accepted accounting procedure. (*Appeal of Amaya*, 2021-OTA-328P.) However, the markup method is only effective and reliable if CDTFA has sufficient information to establish a reasonable markup and the cost of taxable merchandise sold. (*Ibid*.)

Here, CDTFA based the audited weighted taxable markup of 102.24 percent on the results of a purchase segregation test and a shelf test. CDTFA used the purchase segregation test to determine what portion of appellant's purchases were taxable and how appellant's taxable purchases were segregated among categories of merchandise sold by appellant. For the purchase segregation test, CDTFA used the following information for 2016: appellant's purchase journal; and merchandise purchase information from appellant's vendor Sam's Club (a third-party to this appeal). OTA finds that these were sufficiently reliable sources of purchase information because they were for a whole year within the liability period and combined appellant's own books and records with a third-party source of information. As for the shelf test, CDTFA used it to determine the markups for the various categories of taxable merchandise sold

by appellant. For the shelf test, CDTFA used appellant's purchase invoices from April 2018 and POS system sale prices orally obtained from appellant on July 12, 2018. OTA also finds that these were sufficiently reliable sources of information for CDTFA to formulate markups because they were appellant's own records from within the liability period. Using the results of the purchase segregation test and the shelf test, CDTFA computed an audited weighted taxable markup of 102.24 percent. For the reasons stated herein, OTA finds that CDTFA had sufficient information to establish a reasonable markup.

CDTFA based the audited cost of taxable goods sold of $2,223,876 for 2015, 2016, and 2017 on the COGS that appellant reported on its FITRs for those years. CDTFA subsequently adjusted the reported COGS for merchandise that was nontaxable or self-consumed, as well as for "shrinkage" (i.e., loss of inventory due to spoilage, breakage, pilferage, natural disasters, etc.). OTA finds that the COGS appellant reported to the IRS (a third-party to this appeal) on its FITRs is a sufficiently reliable information source for OTA to formulate the audited cost of taxable goods sold. Accordingly, OTA finds that CDTFA had sufficient information to establish audited taxable sales using the markup method. Thus, OTA concludes that CDTFA has carried its initial burden to show that its determination was reasonable and rational, and thus presumably correct; the burden of proof now shifts to appellant to show error in the audit.

On appeal, appellant offers two types of arguments: (1) arguments related to CDTFA's audit; and (2) arguments related to the decision and supplemental decision issued by the Appeals Bureau during and after CDTFA's post-audit internal appeals process. OTA will address both sets of arguments in turn.

Appellant's Audit-Related Arguments

Appellant's audit-related arguments challenge CDTFA's: (a) preliminary examination; (b) purchase segregation test; (c) shelf test and resulting audited weighted taxable markup of 102.24 percent; and (d) discount allowance amount. OTA will address each set of audit-related arguments in turn.

CDTFA's Preliminary Examination

Appellant directs three arguments at CDTFA's preliminary examination. First, appellant argues that CDTFA only found a reporting difference of $104,064 between appellant's FITRs and its SUTRs for 2017, but not for any other years of liability period. Appellant argues that this "inconsistency" fails to justify holding it liable for any higher amount, let alone for unreported taxable sales of $1,666,606. Accordingly, appellant asserts that CDTFA should only apply the markup method to 2017 and not to any other period in the liability period. Second, appellant

contests CDTFA's expected markup of 100 percent for smoke shops on the basis that it lacks support or corroboration. Third, appellant claims that CDTFA used appellant's SUTRs in calculating part of the assessment and appellant's FITRs for the remaining part of the assessment. Appellant assert that this is inconsistent and CDTFA's "reasoning for such inconsistency was that the [FITRs] showing [sic] higher sales," but appellant "do[es] not believe that such simple explanation is enough justification to assess [appellant] with a higher amount."

Regarding appellant's first argument, CDTFA's decision to apply the markup method in its audit of appellant for the liability period was not based solely on a reporting discrepancy between appellant's FITRs and SUTRs for 2017. On the contrary, as recounted above, CDTFA also based its decision on appellant's inconsistent and low book markups and appellant's unreliable bank statements for 2015, 2016, and 2017, a three-year period comprising the bulk of the liability period. Appellant misapprehends why CDTFA used the markup method. Thus, OTA finds appellant's first argument unpersuasive.

Regarding appellant's second argument against an expected markup of 100 percent, it is contradicted by the audited weighted taxable markup of 102.24 percent, which CDTFA computed using a combination of appellant's own records (i.e., purchase journal, purchase invoices, and POS system sale prices) and purchase records from a third-party vendor (Sam's Club). The audited weighted taxable markup of 102.24 corroborated the expected markup of 100 percent. Accordingly, OTA also finds appellant's second argument unpersuasive.

Finally, regarding appellant's third argument about the reporting difference between FITR and SUTRs (presumably for 2017), this argument merely asserts that such difference does not justify a liability. But appellant fails to explain either why there were reporting differences in the first place or why CDTFA erred in basing a liability on them. Further, this argument misconstrues CDTFA's audit. As a preliminary examination, CDTFA compared gross receipts appellant reported on FITRs with taxable sales reported on SUTRs for 2015, 2016, and 2017, ultimately determining that these were not reliable records of appellant's sales. Accordingly, CDTFA turned to the markup method, an indirect audit method, which was the foundation for the bulk of CDTFA's determination. Thus, OTA finds appellant's third argument unpersuasive as well.

In conclusion, for the reasons just described, OTA finds appellant's three arguments regarding CDTFA's preliminary examination unpersuasive.

CDTFA's Purchase Segregation Test

Regarding CDTFA's purchase segregation test, appellant claims that CDTFA used only one month for it, which is too short. Appellant contends that, instead, CDTFA should add an additional month and requests a reaudit by CDTFA.

However, CDTFA based the purchase segregation test on appellant's own purchase journal, as well as merchandise purchase information from Sam's Club, for 2016—one entire year, not just one month. Appellant's challenge to the purchase segregation test rests on a mistaken factual premise. Accordingly, OTA finds this argument lacks merit.

CDTFA's Shelf Test

Regarding CDTFA's shelf test, appellant contends that it fails to account for "price changes." Instead, appellant requests that "CDTFA look at an earlier month in the [liability] period to do its markup shelf test so it can better account for a more holistic average."

However, proving a more accurate markup is now appellant's burden, not CDTFA's. Rather than requesting a reaudit by CDTFA to vindicate its contention, appellant should have considered supplying its own more-accurate markup analysis plus supporting evidence. Without that, appellant's contention is merely an unsupported assertion, which is insufficient to satisfy its burden of proof. (See *Appeal of Las Playas #10*, Inc., *supra*.) Thus, OTA finds appellant's effort to shift the burden of proof back to CDTFA unavailing.

Discount Allowance

Regarding discounts in general, appellant asserts that the shelf test does not account for the "amount" of discounts it offers. Specifically, appellant contends that it offers both "category discounts (age, military, etc.) and bulk discounts (to get client to buy more)" to retain customers and compete in a "very saturated" market. Regarding the 7.75 percent allowance for discounts specifically, appellant asks CDTFA for a reaudit to calculate a "correct" discount percentage, contending that CDTFA should sample the entire liability period "which would likely yield a higher discount."

This argument suffers from the same flaw as appellant's prior argument: it attempts to shift the burden of proof back to CDTFA based on an unsupported allegation. Like the prior argument, OTA concludes that this argument lacks merit for lack of support.

Having found none of appellant's audit-related arguments persuasive, OTA now turns to appellant's arguments relating to the decisions of CDTFA's Appeals Bureau that emerged from CDTFA's post-audit internal appeals process.

Appellant's Arguments Relating to the Decisions of CDTFA's Appeals Bureau

In general, appellant argues that the Appeals Bureau made various statements (or misstatements) in its decision and supplemental decision that undermined aspects of the audit method CDTFA used to determine appellant's liability. Specifically, appellant offers four arguments that OTA will address in turn.

First, related to the audited weighted taxable markup of 102.24 percent, appellant asserts the following: "the Appeals Bureau agreed that … CDTFA unreasonably relied on a related account in making its markup assessment. Therefore, we believe that such data tainted the markup analysis and should be the basis for asking for a reaudit of the business."

However, appellant's argument either ignores or mischaracterizes the record, which indicates that the Appeals Bureau made no such determination nor did CDTFA rely upon a related account in calculating the audited weighted taxable markup of 102.24 percent. Rather, it was appellant who brought up the related account to the Appeals Bureau when it argued that its markup was consistent with the audited markup of 40.86 percent for a partner's Upland smoke shop. However, the Appeals Bureau found that this markup was based on far fewer source documents than the audited weighted taxable markup of 102.24 percent applied in appellant's audit. Further, the Appeals Bureau also determined that the Upland smoke shop's audited markup of 40.86 percent was not applicable to appellant because the Upland smoke shop differed from appellant's business in size and general location. Thus, OTA concludes that CDTFA's markup analysis is not "tainted," appellant's argument wholly lacks merit, and no reaudit is warranted based on this meritless argument.

Second, appellant asserts, "The statement that the business is a 'less affluent area' cannot be used by [CDTFA] to justify assumptions it made during the audit."

Here, CDTFA did not make the "less affluent area" comment during its audit of appellant. Rather, in its decision, the Appeals Bureau used the quoted language to describe part of CDTFA's argument distinguishing the Upland smoke shop (and its audited markup of 40.86 percent) from appellant's smoke shop. The Appeals Bureau did not utilize the language in its analysis. Instead, the Appeals Bureau distinguished appellant's Costa Mesa smoke shop from the Upland smoke shop by their differing sizes and geographic locations (Orange County versus San Bernardino County), and not by any economic indicators. Moreover, appellant has failed to explain why CDTFA could not use economic indicators in its analysis (assuming these indicators were adequately supported by evidence or data). For these reasons, OTA finds appellant's assertion unpersuasive.

Third, appellant contends that CDTFA should have "considered" the data in the gross profit margin summary report because the Appeals Bureau found that the report's recorded taxable sales reconciled with reported taxable sales.[12]

Here, based on the record, CDTFA and the Appeals Bureau did, in fact, "consider" the gross profit margin summary report and its data but the Appeals Bureau concluded that they did not justify any adjustments. During its internal appeals process, CDTFA argued that appellant failed to provide any source documentation to support that data. The Appeals Bureau's decision noted that during CDTFA's preliminary examination of appellant's books and records during the audit it impeached appellant's reported taxable sales and, by proxy, any data reconciling with it. On appeal to OTA, appellant has failed to show how the gross profit margin summary report and its data undermine CDTFA's audit determination. Accordingly, OTA is not persuaded by this contention.

Fourth, appellant reiterates an argument from its request for reconsideration from the Appeals Bureau: "[A]s to the markup, we believe that the Appeals Bureau misstated the markup amounts. On the markup papers dated 2/8/19, [appellant] observes a higher calculated markup for at least some of the audit period." During CDTFA's internal appeals process, the Appeals Bureau asked appellant to clarify this argument, but it failed to do so. OTA's review of the record, particularly the Appeals Bureau's decisions, fails to reveal how the Appeals Bureau purportedly "misstated the markup amounts." Further, OTA reviewed the audit working papers and found only one page dated "02/08/19," a schedule entitled "Audit Findings Summary." This schedule summarizes the audit items (and their respective measures) comprising appellant's total liability but lists no markups. Accordingly, OTA concludes that appellant's argument fails to show that CDTFA's liability determination is incorrect.

In summary, OTA finds that CDTFA could not verify the sales appellant reported on its SUTRs using a direct audit method. Instead, CDTFA used an indirect audit method, the markup method, and the books and records that were either provided or obtained to determine appellant's audited liabilities. OTA found CDTFA's determination to be reasonable and rational, but appellant has only provided inaccurate and unsupported contentions in trying to show the determination was incorrect. Because appellant has failed to meet its burden of proof, OTA concludes that the amount of unreported taxable sales should not be reduced.

[12] For accuracy, OTA quotes appellant's argument in its entirety: "Also, the Appeals Bureau agreed that the margin was supported (reconciled) with the sales data, so there is no reason for [CDTFA] to not have considered the data."

Issue 2: Whether appellant was negligent.

If any part of a 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).) 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 determine the correct tax liability under the Sales and Use Tax Law and all records necessary for the proper completion of SUTRs. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).) Such records include but are not limited to: (1) 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 or working papers used in connection with the preparation of the tax returns. (Cal. Code Regs., tit. 18, § 1698(b)(i).) All records required to be retained under Regulation section 1698 must be preserved for at least four years unless CDTFA authorizes otherwise in writing. (Cal. Code Regs., tit. 18, § 1698(i).) Failure to maintain and provide complete and accurate records will be considered evidence of negligence and may result in penalties. (Cal. Code Regs., tit. 18, § 1698(k).)

Generally, 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. (Cal. Code Regs., tit. 18, § 1703(c)(3)(A); see also *Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 321-324.)

CDTFA added at 10 percent negligence penalty of $13,982.52 to appellant's determination after finding that appellant failed to maintain adequate books and records and accurately report its taxable sales for the liability period.

On appeal, appellant requests the removal of the negligence penalty because any reporting discrepancies resulted from its CPA who had health issues and passed away in 2022. Appellant claims that the CPA's health issues affected the preparation of the SUTRs and FITRs that were filed during the liability period.

Here, upon audit, appellant did not provide CDTFA with the following documents of original entry: sales receipts and purchase invoices for most of the liability period, and POS z-tapes for the entire liability period. Appellant's failure to provide these books and records is evidence of negligent recordkeeping. Additionally, appellant underreported its taxable sales by $1,666,606, a large discrepancy that equates to an error rate of 44.08 percent. The amount of underreporting and the error ratio are significant and evidence of negligent reporting. Although CDTFA had not previously audited appellant, CDTFA did audit one of its partners, M.K. Kakish, who operated a smoke shop in Upland, California, for at least 10 years before appellant. OTA finds this prior audit, combined with the partner's business and industry experience, must have imputed to appellant the knowledge of the requirements for adequately maintaining books and records and accurately reporting its sales. Finally, although appellant claims that its CPA's health issues affected its reporting, the record does not support this claim. The evidentiary record indicates that on January 22, 2019, appellant's authorized representative informed CDTFA that she had cancer and had been extremely sick since November 2018. However, November 2018 is after the liability period, which ended in September 2018. It is also after August 2018, when appellant incorporated its business and would have started reporting under a different seller's permit account. Accordingly, for the reasons stated here, OTA finds that appellant's failure to maintain books and records, together with its substantial underreporting, cannot be attributed to a good faith and reasonable belief that its bookkeeping and reporting practices were in substantial compliance with the Sales and Use Tax Law and authorized regulations.

Therefore, OTA concludes that appellant was negligent, and CDTFA properly imposed the negligence penalty on appellant.

HOLDINGS

1. The amount of unreported taxable sales should not be further reduced.
2. Appellant was negligent.

DISPOSITION

OTA sustains CDTFA's decision and supplemental decision to conditionally relieve appellant of a finality penalty and to unconditionally relieve appellant of a collection cost recovery fee, but to otherwise deny appellant's administrative protest.[13]

DocuSigned by:
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Andrew Wong
Administrative Law Judge

We concur:

DocuSigned by:
Sheriene Anne Ridenour
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Sheriene Anne Ridenour
Administrative Law Judge

Signed by:
Heather Boyd
FC3C746C471043A...
Heather Boyd
Administrative Law Judge

Date Issued: 11/21/2025

[13] *Ante*, fn. 2.