OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18011904
	) CDTFA Case ID 844899
AMG CARE COLLECTIVE	) CDTFA Account No. SR DFB 101-307674
	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Joseph F. Micallef, Sr.
For Respondent:	Scott Lambert, Hearing Representative
For Office of Tax Appeals:	Deborah Cumins, Business Taxes Specialist III

M. GEARY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561 and California Code of Regulations, title 18, section 35019, appellant AMG Care Collective appeals a Decision and Recommendation (Decision) issued by respondent California Department of Tax and Fee Administration (respondent).[1] The Decision was respondent's response to appellant's administrative protest of: 1) a Notice of Determination (NOD) which established an understatement of reported taxable sales of $1,858,568 and assessed a liability of $171,844.60 of additional tax, a negligence penalty of $17,184.49, and applicable interest, for the period January 1, 2010, through December 31, 2012 (liability period), and 2) the respondent's assessment of a finality penalty of $17,184.46 after the NOD became final.[2] In its

[1] Sales and use taxes (and other business taxes and fees) were formerly administered by the State Board of Equalization (BOE). In 2017, the California Legislature transferred functions of the BOE relevant to this case to respondent California Department of Tax and Fee Administration. (Gov. Code, § 15570.22.) The effective date of the transfer of all but adjudicatory functions was July 1, 2017. (Adjudicatory functions were transferred to the Office of Tax Appeals effective January 1, 2018.) For ease of reference, we will use the term "respondent" herein to refer to both the BOE and respondent. When referring to events that occurred before July 1, 2017, the term will refer to the BOE; and when referring to events that occurred on or after July 1, 2017, the term will refer to respondent.

[2] The penalty was added because the liability became final when the taxpayer did not appeal the determination or pay the liability within 30 days after the date of the NOD. (See R&TC, §§ 6561 and 6565.) Respondent has agreed to delete the penalty on certain conditions discussed below.

Decision, respondent reduced the understated measure of tax from $1,858,568 to $1,678,574, deleted the negligence penalty, and recommended relief of the finality penalty, on the condition that appellant pays the tax portion of the liability within 30 days from the issuance of the notice of final decision in this matter, but otherwise denied the administrative protest.[3]

Having failed to submit a timely request for an oral hearing, appellant is deemed to have waived its right to one, and this appeal will therefore be decided on the written record.

ISSUES[4]

1. Did respondent properly mail the NOD?
2. Are additional adjustments to the audited understatement of reported taxable sales warranted?

FACTUAL FINDINGS

1. At all times relevant, appellant operated a retail medical cannabis dispensary in Bakersfield, California, selling cannabis products for medicinal use, based on doctors' recommendations. Subsequent to the liability period, appellant's business expanded to include the retail sale of cannabis for recreational use.[5]
2. During the audit period, appellant's accountant prepared federal income tax returns (FITR's), sales and use tax returns (SUTR's), and appellant's general ledger from bank statements supplied by appellant.

[3] In its analysis of whether the finality penalty should be relieved, respondent found there was evidence that 1) appellant's failure to timely pay the NOD was due to reasonable cause and circumstances beyond the taxpayer's control and occurred notwithstanding the exercise of ordinary care and in the absence of willful neglect, and 2) appellant had a reasonable basis for withholding payment of the tax until resolution of the administrative protest. Accordingly, respondent found that relief was warranted pursuant to R&TC section 6592. In accordance with respondent's Memorandum Opinion issued in the *Appeal of Davinder Singh Pabla, et al.* (SBE Memo.) 2005 WL 2377713, respondent conditioned its recommendation for relief on appellant's payment of the tax portion of the liability within 30 days from the date of mailing of the notice of final decision in this matter.

[4] In the opening brief, appellant also protests the application of the negligence penalty. However, that penalty already has been deleted by respondent. Therefore, we do not address it further.

[5] The recreational use of cannabis by adults 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.

3. During the liability period, appellant reported total sales of $796,765, claimed deductions for sales tax reimbursement included in the selling price of $53,013, and reported taxable sales of $743,752.[6]
4. Respondent first notified appellant regarding the audit in September 2012. On October 27, 2012, appellant executed a general power of attorney (POA) appointing an accounting firm (Rep 1), which shortly thereafter provided a copy of the POA to respondent. The audit was assigned to the Culver City District Office.
5. For audit, appellant initially provided FITR's for 2010, 2011, and 2012, SUTR's for the liability period, a general ledger for the liability period, bank statements for 2010, 2011, and 2012, and a price sheet. Later, appellant provided some cash register Z-tapes[7] for 2010, 2011, and 2012.
6. The price sheet provided by appellant showed prices in four quality (grade) levels. The price sheet showed prices for one gram (the equivalent of approximately one-twenty-eighth of an ounce), one-eighth of an ounce (eighth), and one-fourth of an ounce (fourth) of each grade. The prices for each of those quantities, respectively, were: $5, $15, and $30 for grade 1; $10, $35, and $70 for grade 2; $15, $40, and $80 for grade 3; and $20, $50, $100 for grade 4.
7. According to the audit work papers and respondent's Decision, appellant stated that it did not ring individual sales on the cash register as they occurred. Appellant further explained that it rang all sales on the cash register using the "no sale counter" key, and at the end of the day, appellant recorded its total credit card sales, but it recorded only the difference between the cash on hand at the end of the day and cash on hand at the beginning of the day as its cash sales.
8. Appellant provided no business records that could be used to verify that the proceeds of all cash sales during the liability period were deposited to the bank account for which appellant provided records.

[6] This amount of reported taxable sales would equate to approximately $20,660/quarter, $6,887/month, and $265/day.

[7] Z-tapes are point-of-sale terminal (register) summaries of transactions. Typically, the terminals can be programmed to provide tapes containing various levels of data, including price, tax, and the method of payment (i.e. cash, check or credit card).

9. In its preliminary review, respondent found that total sales reported on SUTR's reconciled with gross receipts reported on FITR's and substantially reconciled with amounts deposited in the bank. However, respondent found that appellant had deposited no cash in the bank for six months during the liability period, four of which were consecutive,[8] and that the ratios of cash deposits to total bank deposits – 28 percent[9] for 2010, 17 percent for 2011, and 20 percent for 2012 – were much lower than what respondent expected, based on its experience auditing similar businesses.

10. Respondent used the amounts of gross receipts and cost of goods sold reported on the FITR's to compute achieved markups[10] of 90 percent for 2010, 72 percent for 2011, and 122 percent for 2012, and an average markup of 85 percent for the three years combined.

11. Respondent did not have an expected markup for this type of business. Further, respondent noted that the amounts of recorded and claimed purchases could not be verified and relied upon because there were virtually no internal controls for cash receipts and cash expenditures, and appellant could have used untraceable cash (from unrecorded sales) to purchase goods for resale. Thus, because respondent could not verify the costs of goods sold, it found achieved markups to be an unreliable basis for determining taxable sales.

12. Ultimately, respondent decided to use an observation test to establish audited sales. Appellant did not permit audit staff to conduct observations of actual sales in the dispensary; therefore, staff observed from outside, counting the number of customers entering the dispensary. The observations were conducted on Tuesday, July 23, 2013, from 10 a.m. until 11:30 a.m., Thursday, July 25, 2013, from 2:00 p.m. until 3:30 p.m., and Friday, August 9, 2013, from 11:30 a.m. until 2:00 p.m., for a total of 5 hours and 30

[8] Appellant deposited no cash in the bank for August 2011 and five months in 2012 (February, March April, May, and July).

[9] Many of the percentages herein, including this 28 percent, are rounded.

[10] "Markup" is the amount by which the cost of merchandise is increased to set the retail price. For example, if the retailer's cost is $.70 and it charges customers $1.00, the markup is $0.30. The formula for determining the markup percentage is markup amount ÷ cost. In this example, the markup percentage is 42.86 percent (.30 ÷ .70 = 0.42857). A "book markup" (sometimes referred to as an "achieved markup") is one that is calculated from the retailer's records. 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 (.30 ÷ 1.00 = 0.3).

minutes.[11] During that period, 53 customers entered the dispensary, or an average 9.64 customers per hour.

13. Respondent conservatively estimated that the average purchase amount was $35 and therefore computed average hourly sales of $337 (9.64 x $35). Respondent computed that the dispensary was open 2,574 hours per year (49.50 hours per week x 52 weeks) and computed audited annual sales of $867,438 ($337 x 2,574) and quarterly sales of $216,860 ($867,438÷ 4).

14. Respondent used the audited sales per quarter to compute audited taxable sales of $2,602,320 ($216,860 x 12 quarters), which exceeded reported taxable sales of $743,752 by $1,858,568.

15. Appellant executed Waivers of Limitation, which extended the statute of limitations by authorizing respondent to issue an NOD for the period November 1, 2009, through March 31, 2011, on or before July 31, 2014.

16. On January 24, 2014, Rep 1 informed respondent that it was transferring the audit to California Sales Tax Consultants (Rep 2) in Sacramento and that a principal of that firm would be contacting respondent.

17. On February 6, 2014, respondent, having heard nothing from Rep 2, attempted to reach that firm by telephone, calling the two telephone numbers that were included in respondent's database. One was a wrong number and the other had been disconnected. Respondent called Rep 1, which stated that it would contact appellant or Rep 2 and call back.

18. In or around February or early March 2014, Rep 2 requested a copy of the audit file from respondent's Sacramento headquarters.

19. On June 11, 2014, respondent spoke by telephone to Rep 2, who acknowledged that the audit would be finalized and billed, but asked respondent to wait until June 13, 2014, to do so.

[11] During the liability period, dispensary hours of operation were 10:30 a.m. to 7:00 p.m. on Monday through Friday and 11:00 a.m. to 6:00 p.m. on Saturday (closed on Sunday).

20. On June 20, 2014, respondent timely issued to appellant an NOD for tax of $171,844.60 and a negligence penalty of $17,184.49. Respondent mailed the NOD to appellant's address of record, but it inadvertently mailed a copy of the NOD to Rep 2 at an incorrect address.
21. There is no evidence in the record to show that appellant executed or filed with respondent a POA appointing Rep 2.[12]
22. Appellant did not file a timely petition for redetermination.
23. On July 21, 2014, when the NOD became final, a finality penalty of $17,184.46 was added to appellant's liability.
24. On August 26, 2014, appellant filed an untimely petition, which respondent accepted as an administrative protest.[13]
25. On April 18, 2017, respondent's Appeals Bureau held an appeals conference with appellant's representatives and audit staff.
26. At the conference, audit staff recommended deletion of the negligence penalty because this was the first audit of the business. Also, at the conference, appellant provided evidence that it had been closed from mid-February 2012 through the end of April 2012. On the basis of that information, BTFD recommended that audited taxable sales of $216,860 per quarter be reduced by 50 percent (to $108,430) for the first quarter 2012 (1Q12) and by 33 percent (to $145,296) for 2Q12.
27. On August 30, 2017, respondent issued its Decision in which it deleted the negligence penalty, reduced the audited understatement of reported taxable sales by $179,994 for the period of time appellant's dispensary was closed, and recommended relief of the finality penalty on the condition that appellant pays the tax portion of the liability within 30 days of the issuance of the notice of final decision in this matter, but otherwise denied the administrative protest.
28. This timely appeal followed.

[12] The evidence provided by appellant includes a copy of a letter dated January 14, 2014, and signed by appellant. The letter is addressed to respondent's Executive Director in Sacramento. We discuss this letter in more detail below.

[13] An administrative protest is reviewed in the same manner as a petition for redetermination. (Cal. Code Regs., tit. 18, § 5220; see also, Cal. Code Regs., tit. 18, § 35019.)

DISCUSSION

Issue 1. Did respondent properly mail the NOD?

R&TC section 6486 provides that respondent shall give written notice of its determination to a retailer. A notice placed in a sealed envelope, with postage paid, addressed to the retailer at his or her address as it appears in respondent's records is deemed complete at the time of the deposit of the notice with the United States Post Office. (R&TC, § 6486.)

In this case, respondent mailed the NOD to appellant's address of record on June 20, 2014. It also mailed copy of the NOD to Rep 2 but sent that copy to an incorrect address.

Appellant states that it directed respondent in January 2014 to mail all written communications, which would include the NOD, to Rep 2. In support, it provided a copy of a letter dated January 14, 2014, and bearing what appears to be appellant's signature. As relevant here, the letter instructs respondent to "direct all written and/or telephone communications" to Rep 2. Rep 2 states that appellant did not receive the NOD mailed to it. It argues that respondent did not comply with appellant's instruction, which respondent acknowledges, and that the NOD therefore does not meet the legal requirements of R&TC sections 6486 and 6487 because respondent did not mail the NOD to Rep 2. On this basis, appellant concludes that the NOD is barred by the statute of limitations and the appeal should be decided in favor of appellant.

Respondent responds that the NOD is valid because it was mailed to *appellant's* address of record, that the NOD was, therefore, timely mailed, and that it was not rendered invalid by respondent innocently but erroneously mailing the copy to appellant's representative at an incorrect address.

There is no question that respondent mailed the NOD within the extended statute of limitations. Waiver 2 required that the NOD be mailed on or before July 31, 2014. Respondent mailed it on June 20, 2014. The question is whether mailing the NOD to appellant only, and not also to Rep 2, was sufficient.

Section 6486 provides for service of an NOD, and it does not require delivery to a taxpayer's representative. (*Pac. Gas & Elec. Co. v. State Bd. of Equal.* (1955) 134 Cal.App.2d 149, 152-155.) It requires respondent to mail the NOD to the retailer at its address of record. That is not to say that a taxpayer may not choose to substitute a representative as the sole

recipient of notices, but it would do so at its own risk. Representatives sometimes come and go, and the taxing agency is not always promptly informed about withdrawals or substitutions. The parties have not cited a case on point, and we have not found one. However, there are federal cases, which may shed some light on the subject.

Internal Revenue Code (IRC) section 6212 provides that in the absence of notice of the existence of a fiduciary relationship, a notice of deficiency must be mailed to the taxpayer at its last known address of record. Generally, Treasury Regulation 301.6212-2(a) defines "last known address" as "a taxpayer's last known address is the address that appears on the taxpayer's most recently filed and properly processed Federal tax return, unless the Internal Revenue Service (IRS) is given clear and concise notification of a different address." (See also Rev. Proc. 90-18 (IRS RPR), 1990-13 I.R.B. 19, 1990-1 C.B. 491, 1990 WL 624977.)

In *Mulvania v. Commissioner* (9th Cir. 1985) 769 F.2d 1376 (*Mulvania*), the government appealed a decision of the United States Tax Court, which found that the IRS Commissioner lacked jurisdiction to assess a deficiency against taxpayer, who did not receive valid notice of the proposed assessment within the three-year statute of limitation. The IRS had attempted to send the notice to taxpayer, but the notice was returned because the address was wrong. The IRS had also sent a copy of the notice to taxpayer's accountant, who held taxpayer's POA requesting that copies of all documents sent to taxpayer also be sent to the accountant. The accountant later learned during a discussion with taxpayer that Mulvania had not received the notice. While the accountant believed the deficiency notice was not valid because it was not sent to taxpayer, the accountant eventually filed a petition for redetermination after the time to do so had expired.[14] The Tax Court found that it lacked jurisdiction to enforce the assessment because the IRS failed to give proper notice.

On appeal, the IRS argued that the notice was proper because taxpayer's accountant received a copy of the notice, and had actually discussed the notice with taxpayer, before the time to file a petition for redetermination had expired. Taxpayer argued that a courtesy copy to a representative is not the required notice to a taxpayer, even when the representative tells the taxpayer about the notice.[15] The Court made two observations potentially relevant to our issue.

[14] IRC Section 6213(a) permits a taxpayer to whom a notice of deficiency is mailed to file a petition in the Tax Court within 90 days after the notice is mailed.

[15] There was no evidence that the accountant told Mulvania what the notice said.

It stated that "With a broad [POA], registered notice to the attorney or accountant may also serve as notice to the taxpayer under the law of principal and agent *if the taxpayer himself received some notification in time to file a petition before the tax court*." (*Mulvania, supra*, at p. 1379; emphasis added.) It also observed that a taxpayer may designate a representative's address "as that to which any deficiency notice should be sent." (*Ibid*.) Ultimately, the Court found for the taxpayer, stating, "It is better for the government to lose some revenue as the result of its clerical error than to create uncertainty. If [the accountant], either intentionally or unintentionally, had not informed Mulvania of the receipt of the copy of the notice of deficiency, then Mulvania would not have received any notification of the deficiency. Tax law requires more solid footings than the happenstance of a tax adviser telephoning a client to tell him of a letter from the IRS." (*Id*., at p. 1380.)

A few years later, the Ninth Circuit examined a Tax Court case in which taxpayer filed a late appeal and argued that it did not receive proper notice of the claimed deficiency because the IRS did not send the notice to his last-known address. In *McKay v. Commissioner* (1989) 886 F.2d 1237, the evidence revealed that taxpayer received a copy of the notice from his attorney when there was still adequate time for him to file a petition for redetermination. Observing that actual notice is the primary goal of IRC section 6212(b)(1), regardless of how that actual notice is delivered, the Court found for the IRS and sustained the Tax Court's dismissal of the late petition for redetermination. (*Id*., at p. 1239.)

We agree that actual and timely notice to the taxpayer is the goal, but R&TC section 6486 does not require that the appellant receive the NOD. The evidence shows that respondent mailed the NOD to appellant, though not to Rep 2. Pursuant to R&TC section 6486, the giving of notice is deemed complete when the NOD was mailed to the taxpayer. Thus, respondent did what the law requires. On that basis, we find that the mailing of the NOD to appellant's last-known address was sufficient. Although this finding is dispositive of this issue, we will also address appellant's argument that respondent was required to send the notice (or a copy thereof) to appellant's representative.

Unlike IRC section 6212(b)(1), which at least implies that the existence of a fiduciary relationship known to the IRS may affect the notice requirements, R&TC section 6486 requires only that the notice be mailed to the retailer at its last-known address. As indicated above, there is nothing to prevent a taxpayer from designating the address of its representative as the address

to which notices should be sent, but unless there is a clear and concise direction that the representative's address shall be deemed appellant's mailing address for all purposes, such designation is properly deemed by the taxing agency to be a request that courtesy copies be sent to the representative.[16] Furthermore, R&TC section 6486 does not require respondent to mail an NOD to an address other than a taxpayer's *one* address of record to satisfy the "mailed within three years" requirement of R&TC section 6487. (*Chapman v. Commissioner*, T.C. Memo. 2019-110 [citing *Abeles v. Commissioner* (1988) 91 T.C. 1019, 1030].) To hold otherwise would subject taxpayers to the risk referred to above, as well as the risk that the representative, if still under an obligation to the taxpayer at the time of the notice, will simply fail to take appropriate action, including giving the notice to the taxpayer. It is just that kind of uncertainty that the Ninth Circuit cautions about. (*Mulvania, supra*, at p. 1380.) In addition, allowing taxpayers to designate certain representatives as the only authorized recipients of notices regarding only particular matters would place an impossible burden on taxing agencies and create a situation that would be ripe for abuse and lead to a proliferation of disputes.

We also note that the January 14, 2014 letter in no way constitutes a general power of attorney, and we have no evidence to show that appellant ever appointed appellant as his attorney-in-fact. Furthermore, we find that the letter is not sufficiently clear and concise to be a request to respondent designating the address of its representative as the one address to which all notices should be sent. Consequently, the NOD was mailed to appellant's address of record.

Finally, there is no evidence before us to show that appellant has been prejudiced by respondent's failure to send Rep 2's copy of the NOD to the correct address. Appellant's untimely petition was accepted as a late protest, and his appeal has been processed in the same way a timely petition would have been processed. While a finality penalty was applied by respondent, it has agreed to delete the penalty on the usual and reasonable condition that it pay the amount due within 30 days.

Thus, we find that respondent properly and timely mailed the NOD to appellant.

[16] There are cases that characterize copies sent to a taxpayer's representative as courtesy copies. (*Mulvania, supra*, at p. 1380; see also, *Houghton v. Commissioner* (1967) 48 T.C. 656, (citing *Draper Allen* (1957) 29 T.C. 113.) But ours is more a logical conclusion than a legal proposition. The taxing agency *must* send the required notice to the taxpayer's last known address, but it *may* also send a copy to the taxpayer's representative, if so authorized.

Issue 2. Are additional adjustments to the audited understatement of reported taxable sales warranted?

The California sales tax is imposed on a retailer's retail sales in this state of tangible personal property, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, § 6051.) All of a retailer's gross receipts are presumed subject to tax, unless the retailer can prove otherwise. (R&TC, § 6091.) It is the retailer's responsibility to maintain complete and accurate records and to make them available for examination. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).)

If respondent is not satisfied with a taxpayer's returns, it may compute and determine the amount required to be paid upon the basis of the facts contained in the returns or upon the basis of any information within the Board's possession or that may come into its possession. (R&TC, § 6481.) When a taxpayer challenges an NOD, respondent has a minimal, initial burden of showing that its determination is reasonable and rational. (See *Schuman Aviation Co. Ltd. v. U.S.* (D. Hawaii 2011) 816 F.Supp.2d 941, 950; *Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Myers* (2001-SBE-001) 2001 WL 37126924.) If respondent carries that burden, the burden of proof shifts to the taxpayer to show that a result differing from respondent's determination is warranted. (*Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 616.) The applicable burden of proof is by a preponderance of the evidence. (Cal. Code Regs., tit.18, § 30219(c).) That is, a party must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Concrete Pipe and Products of California, Inc. v. Construction Laborers Pension Trust for Southern California* (1993) 508 U.S. 602, 622.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Magidow* (82-SBE-274) 1982 WL 11930.) To satisfy the burden of proof, a taxpayer must prove that (1) the tax assessment is incorrect, and (2) the proper amount of the tax. (*Paine v. State Bd. of Equalization* (1982) 137 Cal.App.3d 438, 442; *Honeywell, Inc. v. State Bd. of Equalization* (1982) 128 Cal.App.3d 739, 744.)

R&TC section 6481 establishes the broad power of respondent to determine a taxpayer's liability, and the fact that appellant's bank deposit information, FITR's, and cash register Z-tapes substantially reconciled with the amounts reported on SUTR's does not establish that appellant correctly reported taxes due. Appellant did not provide verifiable evidence of sales or purchases, and appellant's stated method of accounting for cash sales – subtracting cash on hand at the

beginning of the day from cash on hand at the end of the day – made it impossible to verify reported amounts. There were no internal controls on the recording of cash sales. The amounts of cash on hand at the end of the day would be what appellant and its employees chose to put and leave in the till. It would not, for example, include cash that had been used intentionally by appellant for purchases of merchandise or supplies, payment of wages, or any other purpose, and it would not include cash that had been lost through theft.

Respondent's concerns about the accuracy of appellant's reporting appears to be borne out by additional evidence. Appellant deposited no cash during six of the 36 months of the liability period. The ratio of cash sales to total sales – 28 percent for 2010, 17 percent for 2011, and 20 percent for 2012, based on appellant's records – appear to be low considering the nature of the business. Also, several of the cash deposits are amounts of even hundreds.

We find that respondent's expectation that the majority of sales would be paid in cash was a reasonable one and that records indicating that almost 87 percent of its total sales were paid by credit or debit card were suspect.[17] This indicated to respondent that appellant did not deposit the proceeds of all sales into its bank account. On this basis, respondent concluded that neither the bank deposits nor the cash register tapes were reliable records that could be used to establish audited sales.[18] We find it was appropriate for respondent to utilize an alternative audit method to establish audited sales.

As described above, respondent decided to use an observation test to establish audited taxable sales. The audit file and Decision state, and appellant has not disputed, that appellant did not allow the audit staff to enter the dispensary. Therefore, respondent's decision to observe from outside, counting the number of patrons entering the dispensary, was reasonable, and there is no evidence to show that the result would have been different if the observations had occurred

[17] Credit card receipts deposited in the bank totaled $644,607 for the liability period, for which appellant reported taxable sales of $743,752. As a comparison, the total credit card receipts of $644,607 represent approximately 27 percent of audited taxable sales of $2,422,326.

[18] We note that neither party has argued that the Z-tapes are reliable indicators of sales, and our cursory review of the Z-tapes confirms they have little, if any evidentiary value. They appear to show total sales, broken down to cash sales and credit/debit card sales, with cash sales to total sales percentages in the 45 to 55 percent range during the early documented months (May 2010) but much lower cash percentages later. The Z-tapes also appear to show huge and unexplained variations in total daily sales (e.g., two weeks of daily sales of between $457 and $7,292 sandwiched between periods of daily sales in the low- to mid-$30,000s). There are also multiple but different Z-tapes for at least one day (Z-tapes for June 29, 2010, and apparently printed at 6:46 and 6:55 p.m., show total sales of $13,801.90 and $35,964.18, respectively). Finally, the total sales amounts reported on later Z-tapes appear to show steady and significant – if not incredible – increases in total daily sales from $22,676 on August 11, 2010, to $586,239.68 on January 28, 2012, followed by an April 25, 2012 Z-tape purporting to show total daily sales of $702.

from inside the dispensary. Respondent made its observations on three different days, none of which was a Saturday. The total time of observation was 5.5 hours, and respondent computed an average of 9.64 customers per hour. Respondent concluded that each patron made a purchase, and it used an average amount of $35 for each purchase, which was the cost of one- eighth of an ounce of grade 2 (of 4) quality. Using the number of hours of operation, the number of patrons per hour, and the $35 estimated purchase amount, respondent computed audited sales of $216,860 per quarter.[19]

Appellant argues that the test was not for sufficient periods of time to be representative of its business throughout the liability period. Respondent acknowledges as much but concluded during the agency appeal process that additional testing was not feasible in this case because, since the liability period, marijuana sales for recreational use have been legalized in California. As a result, appellant has more potential customers, and sales made in the current period are expected to be significantly higher than those made during the liability period. We concur with respondent's conclusion that further testing is not a viable option.

We recognize that 5.5 hours of observation is far less than the minimum time established by section 0810.30 of respondent's Audit Manual (Audit Manual), which recommends three full observation days to project sales;[20] however, for several reasons, we do not find that the audit results should be disregarded, or even adjusted, on that basis alone. This alternative methodology was necessary because appellant did not provide verifiable records for audit. According to respondent's Assignment Activity History (Form 414Z, part of the audit work papers), appellant specifically refused respondent's request for sales and purchase invoices because it was concerned about federal laws, and, while appellant and its Rep 1 had many questions about the observation test at the time of the exit conference on December 30, 2013 (e.g., How many observers? Where were they standing?), respondent recorded no objections to the amount of observation time. If such an objection had been stated then, respondent would have had an opportunity to conduct further observations before circumstances changed. We also note that, while respondent's observations did not include times after 3:30 p.m. or any Saturday hours, there is no evidence that customer traffic would have been diminished during those times.

[19] This amount equates to approximately $72,287 per month and $2,780 per day.

[20] 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>

On the contrary, we would expect there to be more customer traffic on a Saturday. Finally, respondent's Audit Manual does not necessarily represent the minimum threshold for establishing a reasonable and rational basis for a determination. Under the specific facts presented here, we find that respondent met its initial burden, and it is incumbent on appellant to prove a more accurate result.

Appellant also argues that we should defer our consideration of this appeal pending respondent's completion of an audit of appellant for a later period. It states that the business has been selected again for audit and proposes that the findings of the audit of the later period could be utilized to establish the understatement for the period in dispute here. Appellant states that the findings of the audit of the later period could be applied to the audit of the years 2010 through 2012, after adjustment for changes since 2012 (such as the legalization of marijuana sales for recreational use, differences in the geographical location and size of the store, the number of employees, and the diversity of the business locations). Respondent has not commented on this suggestion, and, absent a stipulation to defer consideration of this appeal pending further investigation by respondent, we are compelled to address the issues presented by applying the correct legal principles to the facts shown by the evidence.

Appellant also at least implies disagreement with respondent's conclusions that each patron who entered the dispensary made a purchase and that the amount of that purchase was $35. We have already found that respondent has met its initial burden of showing a reasonable and rational basis for its determination. Our finding, above, includes respondent's conclusion that each person who entered the premises made a $35 taxable purchase.[21] Appellant cannot meet its burden by simply challenging respondent's methodology. It must establish error and prove a more accurate determination. It has not carried its burden.

Based on the evidence, we find that additional adjustments to the audited understatement of reported taxable sales are not warranted.

[21] Appellant sold medicinal cannabis products to customers who used it to alleviate symptoms. It was reasonable for respondent to conclude that every customer who entered the dispensary did so with the intention of purchasing medicinal cannabis and that every customer purchased medicinal cannabis. Appellant advertised prices for three quantities of four grades of cannabis. Respondent concluded that the average purchase was equal to the retail price of an eighth of grade 2, which was also the average price for an eighth. This conclusion, too, was reasonable and rational.

HOLDINGS

1. Respondent properly mailed the NOD.
2. Additional adjustments to the audited understatement of reported taxable sales are not warranted.

DISPOSITION

We sustain respondent's decision to: reduce the audited understatement of reported taxable sales from $1,858,568 to $1,678,574; delete the negligence penalty; and relieve the finality penalty if the tax portion of the liability is paid within 30 days from the date of mailing the notice of final action in this case.

DocuSigned by:
1A9D52EF88AC4C7...
Michael F. Geary
Administrative Law Judge

We concur:

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

DocuSigned by:
B90E40A720E3440...
Josh Lambert
Administrative Law Judge

Date Issued: 4/6/2020