OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18083562
	) CDTFA Case IDs: 862334, 957652
WMG CENTER, INC.	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Warren Nemiroff, Attorney Vic Mann, Vice President
For Respondent:	Randy Suazo, Hearing Representative Christopher Brooks, Tax Counsel IV Jason Parker, Chief of Headquarters Ops.
For Office of Tax Appeals:	Lisa Burke, Business Taxes Specialist III

A. WONG, Administrative Law Judge: Pursuant to California Code of Regulations, title 18, section 35019, and California Revenue and Taxation Code (R&TC) section 6901, WMG Center, Inc. (appellant) appeals a Decision and Recommendation (D&R) issued by respondent California Department of Tax and Fee Administration (CDTFA) denying, in part, appellant's administrative protest of a Notice of Determination (NOD) dated November 4, 2013, for the period of June 15, 2011, through June 17, 2012 (liability period), as well as appellant's timely claim for refund dated May 9, 2016.[1] The NOD was for sales tax of $91,312.23, a negligence penalty, and applicable interest. Appellant did not file a timely petition for redetermination, so CDTFA's determination became final, and a finality penalty was added thereto.[2] CDTFA received funds totaling $130,617.80, which fully satisfied appellant's tax

[1] The California State Board of Equalization (BOE) formerly administered sales and use taxes. In July 2017, CDTFA assumed from BOE functions relevant to this case. (Gov. Code, § 15570.22.) For ease of reference, when this Opinion describes acts or events that occurred before July 1, 2017, any references to "CDTFA" refers to BOE.

[2] A finality penalty is the penalty imposed by R&TC section 6565 for a taxpayer's failure to pay a determination when it becomes final (i.e., due and payable).

liability, penalties, and applicable interest.[3] Subsequently, CDTFA reduced the determined measure of sales tax by $433,935, from $1,035,526 to $601,591, which reduced appellant's sales tax liability by $38,264.18, from $91,312.23 to $53,048.05. CDTFA also deleted the negligence penalty and relieved appellant of the finality penalty.

Office of Tax Appeals (OTA) Administrative Law Judges Andrew Wong, Josh Aldrich, and Michael F. Geary held an oral hearing for this matter via Webex on January 24, 2022. At the conclusion of the hearing, we closed the record, and this matter was submitted for decision.

ISSUE

Whether a further reduction to the determined measure of tax is warranted.

FACTUAL FINDINGS

1. Prior to the liability period, from January 10, 2011, through May 19, 2011, appellant, a corporation, operated a retail medical marijuana dispensary in Santa Fe Springs, California. Thereafter, under new ownership, appellant obtained a new seller's permit. During the liability period, appellant operated in the same Santa Fe Springs location. At the end of the liability period, appellant closed its business with no successor.
2. For the liability period, appellant claimed no deductions and reported total/taxable sales of $522,566, which was comprised of the following: $35,509 for the second quarter of 2011 (2Q11); $150,419 for 3Q11; $109,929 for 4Q11; $108,490 for 1Q12; and $118,219 for 2Q12.
3. Upon audit, appellant provided its federal income tax returns for 2011 and 2012, a Form 1099-K issued to appellant for 2011, and daily sales journals and bank statements for the liability period.[4] Appellant did not provide any source documents such as purchase invoices, sales invoices, or cash register tapes.
4. CDTFA found that appellant's reported taxable sales reconciled with the gross receipts reported on the federal income tax returns and the taxable sales recorded in the sales

[3] The $130,617.80 came from the following five sources: (1) $3,096.24 received via bank levy on February 7, 2014; (2) $391.17 received via intercepted state income tax refund on September 23, 2014; (3) $405.07 received via bank levy on February 6, 2015; (4) $17.00 received via bank levy on May 15, 2015; and (5) $126,708.32 received from an escrow account on December 31, 2015, after appellant sold real property.

[4] Form 1099-K (*Payment Card and Third-Party Network Transactions*) is an IRS form showing amounts paid to a merchant by customers using a payment card (i.e., credit card or debit card) or a third-party payment network (e.g., PayPal).

journals with no discrepancies. However, CDTFA found that comparing appellant's reported taxable sales to the cost of goods sold reported on the federal income tax returns revealed book markups of 1,391.14 percent for 2011 and 119.20 percent for 2012. CDTFA expected the book markups to be consistent from year to year, but appellant could not explain the variance, so CDTFA concluded that the amounts appellant reported as taxable sales and cost of goods sold were unreliable.

5. CDTFA observed appellant's business for 30 minutes on October 31, 2011, from 1:02 p.m. to 1:32 p.m., and for 31 minutes on May 10, 2012, from 2:41 p.m. to 3:12 p.m. During its observations, CDTFA counted 18 individuals entering appellant's business on October 31, 2011, and 20 individuals entering the business on May 10, 2012. Assuming that each individual entering the business made a purchase, CDTFA estimated that appellant averaged 37 sales per hour.

6. Based on appellant's selling prices for one-eighth ounce of various strains of marijuana (which CDTFA found online), CDTFA established an average selling price per sale of $48.47.[5]

7. Estimating that 37 customers per hour made purchases of $48.47 each, CDTFA computed audited taxable sales of $1,793.53 per hour and $23,316 per day. CDTFA then multiplied average daily sales of $23,316 by 331 days of operation during the liability period to establish audited taxable sales of $7,717,544, which exceeded appellant's reported taxable sales of $522,566 for the liability period by $7,194,978.

8. Based on its initial analyses, CDTFA considered appellant's reported taxable sales to be substantially understated.

9. CDTFA decided to prepare a credit-card-sales-ratio analysis to establish audited taxable sales. However, appellant stopped accepting credit cards after October 2011, so, by the time of its audit, CDTFA could not use an observation test to determine appellant's credit-card-sales ratio (i.e., the percentage of appellant's total sales that were paid by credit card). Further, when CDTFA compared the taxable sales that appellant recorded in its sales journal to the credit card sales recorded in appellant's Form 1099-K, it found a

[5] CDTFA used the selling prices of one-eighth ounce of marijuana because, according to its audit working papers dated July 31, 2013, one-eighth ounce was the most common quantity of medical marijuana sold by businesses in that industry. As for appellant's selling prices, CDTFA's audit working papers indicated that appellant had "confirmed selling price was higher compared to industry average." At the hearing, Mr. Vic Mann, appellant's corporate vice president, testified, "Our prices were not the cheapest prices." (Oral Hearing Transcript, p. 15.)

credit-card-sales ratio of 70.75 percent, which CDTFA deemed to be unreasonably high for this type of business and industry. Additionally, appellant's bank statements showed inconsistent cash deposits from June 2011 through October 2011, with no cash deposited for one monthlong statement period.[6] Appellant did not provide any source documents to support total sales or the 70.75 percent credit-card-sales ratio.

10. Instead, CDTFA reviewed appellant's reported taxable sales for the period January 10, 2011, through May 19, 2011 (when appellant was under prior ownership), and found that these amounts more closely matched the amounts CDTFA had expected to find based on its observation tests. Thus, CDTFA determined that appellant's information under the prior ownership was the best information available. Using appellant's Form 1099-K information, CDTFA computed that appellant had made credit card sales of $102,403 for 1Q11, compared that amount with appellant's reported taxable sales for 1Q11, and calculated a credit-card-sales ratio of 23.73 percent.

11. CDTFA then divided appellant's credit card deposits of $163,478 for the period June 15, 2011, through October 31, 2011, by the credit-card-sales ratio of 23.73 percent to establish audited taxable sales of $688,909, which represented an error rate of 198.16 percent when compared with appellant's reported taxable sales for that period of $231,052.

12. CDTFA then applied the error rate of 198.16 percent to appellant's reported taxable sales for the liability period of $522,566 to establish unreported taxable sales of $1,035,526.

13. On November 4, 2013, CDTFA issued to appellant an NOD based on unreported taxable sales of $1,035,526 and added a negligence penalty. Appellant attempted to file untimely petitions for redetermination on December 16, 2013, January 30, 2015, and February 12, 2015, which CDTFA accepted as an administrative protest.[7] Because the liability became final before appellant paid the tax, a finality penalty was added to the determination.

---

[6] Per appellant's bank statements, appellant deposited the following amounts of cash per respective monthly period: $36,691 for the period of May 24, 2011, through June 17, 2011; $600 for the period of June 18, 2011, through July 18, 2011; $0 for the period of July 19, 2011, through August 18, 2011; $1,200 for the period of August 19, 2011, through September 19, 2011; $5,000 for the period of September 20, 2011, through October 18, 2011; and $18,876.16 for the period of October 19, 2011, through November 16, 2011.

[7] Prior to the November 4, 2013 NOD, appellant also attempted to prematurely file a petition for redetermination on October 1, 2013.

14. CDTFA held an appeals conference with appellant on November 1, 2016. During that appeals process, appellant provided cash register tapes for the period of December 7, 2011, through December 24, 2011, but CDTFA declined to use them.[8] Nevertheless, CDTFA agreed to expand the period used to compute the audited credit-card-sales ratio to include the period of April 1, 2011, through May 19, 2011 (when appellant was still under prior ownership). This increased the audited credit-card-sales ratio from 23.73 percent to 32.89 percent, which in turn reduced the amount of unreported taxable sales by $433,935, from $1,035,526 to $601,591.

15. In its D&R issued on March 22, 2017,[9] CDTFA recommended reducing the determined measure of tax to $601,591, deleting the negligence penalty, and relieving appellant of the finality penalty, thereby partly granting appellant's administrative protest and its claim for refund. Otherwise, CDTFA recommended denying the administrative protest and the claim for refund.

16. This appeal to OTA followed.

DISCUSSION

California imposes upon a retailer a sales tax measured by the retailer's gross receipts from the retail sale of all tangible personal property sold in this state, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, §§ 6012, 6051.) For the proper administration of the Sales and Use Tax Law and to prevent evasion of the sales tax, the law presumes that all gross receipts are subject to tax until the contrary is established. (R&TC, § 6091.) It is the retailer's responsibility to maintain complete and accurate records to support reported amounts and to make them available for examination. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).)

[8] CDTFA declined to use the December 2011 cash register tapes for four reasons. First, beginning in November 2011, appellant only accepted cash payments, and CDTFA could not verify whether the December 2011 cash register tapes recorded all such sales. Second, the December 2011 cash register tapes suggested that appellant had an average of 7.23 customers per hour, but, during its observation tests, CDTFA observed an average of 37 customers per hour. Third, the December 2011 cash register tapes showed an average selling price per sale of $23.56, which conflicted with CDTFA's estimated average selling price per sale of $48.47. Fourth, appellant had indicated that it did not operate on Sundays, but the December 2011 cash register tapes showed that it did. Because of these discrepancies, CDTFA determined that it was untenable to project appellant's December 2011 sales, as recorded in the cash register tapes, to the rest of the liability period.

[9] The D&R is misdated "March 22, 2016."

If CDTFA is not satisfied with the amount of tax reported by any person, or if any person fails to make a return, CDTFA may determine the amount required to be paid based on any information within its possession or that may come into its possession. (R&TC, §§ 6481, 6511.) In the case of an appeal, CDTFA has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Talavera*, 2020-OTA-022P.) If CDTFA carries its initial burden, the burden of proof shifts to the taxpayer to establish that a result differing from CDTFA's determination is warranted. (*Ibid*.) 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. (*Appeal of AMG Care Collective*, 2020-OTA-173P.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Talavera*, *supra*.) To satisfy the burden of proof, a taxpayer must prove two things: (1) the tax assessment is incorrect; and (2) the proper amount of tax. (*Appeal of AMG Care Collective*, *supra*.)

Here, appellant did not provide a complete set of books and records upon audit. Further, the difference between appellant's book markups of 1,391.14 percent for 2011 and 119.20 percent for 2012 was significant (over 1,000 percent) and suggested that appellant's reported and recorded amounts were unreliable. Additionally, CDTFA computed unreported taxable sales of $7,194,978 based on its two observations of appellant's business and its estimated average selling price per sale of $48.47, which suggested that appellant's reported taxable sales were substantially understated. Given the lack of books and records and CDTFA's findings, we conclude that it was reasonable and rational for CDTFA to use the credit-card-sales-ratio analysis, a recognized and accepted accounting procedure (see *Appeal of Amaya*, 2021-OTA-328P), to establish audited taxable sales and to determine the amount of any understatement.

However, CDTFA's comparison of appellant's credit card sales to appellant's reported total/taxable sales during the portion of the liability period that appellant accepted credit cards yielded a credit-card-sales ratio of 70.75 percent, which CDTFA deemed too high for this type of business. Further, inconsistent cash deposits during the same period (including zero cash deposits for one monthlong period) and the lack of source documents supporting reported total/taxable sales cast doubt upon the 70.75 percent ratio. Instead, CDTFA compared appellant's credit card sales with its reported taxable sales for periods predating the liability

period (i.e., 1Q11 and April 1, 2011, through May 19, 2011, when appellant was under prior ownership) and formulated a credit-card-sales ratio of 32.89 percent. This resulted in unreported taxable sales of $601,591. Given the dearth of reliable books and records, the similar nature and identical location of appellant's business both before and after the start of the liability period, and the relatively lengthy period used to compute the audited credit-card-sales ratio (almost 5 months), we find CDTFA's use of a 32.89 percent credit-card-sales ratio reasonable and rational. Therefore, the burden of proof shifts to appellant to establish with documentation or other evidence that a reduction to the determined measure of tax is warranted.

On appeal, appellant offers five arguments for why the $601,591 determined measure of tax is overstated. We examine each in turn below.

First, appellant contends that CDTFA's observation tests were flawed because no CDTFA auditor entered appellant's business to verify whether individuals entering the business made a purchase and thus represented a sale. Appellant contends that CDTFA's assumption that every individual entering its business made a purchase was faulty because many of these individuals were simply checking prices or were dissatisfied customers returning to complain and left without making a purchase. Appellant also contends that the average selling price per sale of $48.47 is overstated.

Regarding this first argument, we note that CDTFA did not use the two observation tests and estimated average selling price per sale to establish the measure of unreported taxable sales. Rather, CDTFA used these to initially analyze and verify appellant's reported taxable sales of $522,566, and then, after finding these may be substantially understated, to evaluate the reasonableness of the results of its main audit method, the credit-card-sales-ratio method. Even if CDTFA had used the two observation tests to directly establish unreported taxable sales (which it did not), OTA has found it reasonable for CDTFA to conclude that every customer entering a medical marijuana dispensary is seeking to use medicinal cannabis to alleviate symptoms and therefore made a purchase. (See *Appeal of AMG Care Collective*, *supra*.) As for appellant's contention that the average selling price per sale of $48.47 is overstated, again, CDTFA did not use that figure in establishing the determined measure of tax, and, in any case, appellant has not established an alternative by verifiable documentation or other evidence. Accordingly, we are not persuaded by appellant's first argument.

Second, appellant argues that the determined measure of tax is overstated because, during the liability period, a competing dispensary opened nearby, which reduced appellant's sales. Appellant also contends that, during its two observation tests, CDTFA did not distinguish between individuals entering appellant's business and those entering its competitor's business, which was two doors down, and this inflated appellant's average number of customers per hour and, in turn, the determined measure of tax.

Regarding this second argument, we again note that the audit method used by CDTFA to determine the measure of tax was the credit-card-sales-ratio method, not the observation tests. The credit-card-sales-ratio method applies an average credit-card-sales ratio to *known* credit card deposits (i.e., sales) and thus will account for fluctuations in sales over time whether due to competition, seasonal variance, or some other cause. Therefore, we find appellant's second argument unpersuasive.

Third, appellant argues that the only evidence CDTFA used in calculating the determined measure of tax was taken from December 2011, which inflated the audit results because December is the strongest sales month for any business.

However, as noted above, CDTFA declined to use appellant's cash register tapes from that month to calculate the taxable measure.[10] Instead, CDTFA used nearly five months of credit card sales data (January 1, 2011, through May 19, 2011) to calculate a credit-card-sales ratio, which it then used to formulate and apply an error rate to appellant's reported taxable sales for the liability period. Further, the credit-card-sales-ratio audit method already accounts for seasonal variance in sales volume. Thus, appellant's third argument does not undermine CDTFA's audit results.

Fourth, appellant argues that the determined measure of tax is overstated because appellant had almost no business in the last three months of the liability period, leading up to the closure of appellant's business.

[10] See footnote 8, *ante*, page 5. Also, on appeal to OTA, appellant submitted approximately 260 pages of cash register receipts with dates in April 2017 (i.e., after the liability period). Appellant claims that these receipts are misdated and are from April 2012, but has not explained their significance or how they show error in CDTFA's determination. OTA is not required to sort through voluminous and unorganized documentation in an attempt to find errors in CDTFA's determination. (*Appeal of Amaya*, *supra*.) Further, assuming these receipts are from April 2012, we are unable to verify whether they are an accurate record of appellant's sales, which were all in cash at this time. Accordingly, we will not address the April 2017 cash register receipts further.

Appellant's fourth contention is belied by the record, which indicates that appellant's reported taxable sales for 2Q12 ($118,219) were greater than either of the two prior quarters of 1Q12 ($108,490) or 4Q11 ($109,929). Also, at the hearing, appellant's corporate vice president, Mr. Vic Mann, a co-owner of appellant, testified that sales increased during the last quarter of the liability period, explaining that they had decided to close the business and "get rid of all the inventory." (Oral Hearing Transcript, p. 45.) Accordingly, the record does not support appellant's fourth argument. And even if it did, again, the credit-card-sales-ratio method already accounts for fluctuations in sales volume over time.

Finally, appellant argues that it would not have closed its business if, in fact, it had unreported taxable sales of $601,591 during the liability period, implying that the determined measure of tax is overstated.

Regarding this final argument, we reiterate the law: if CDTFA carries its minimal, initial burden of showing that its determination was reasonable and rational (as it has done here), the burden shifts to appellant to establish a different result. (*Appeal of Talavera*, *supra*.) Appellant cannot carry its burden by simply challenging the measure of unreported taxable sales; it must also establish the proper amount of tax. (See *Appeal of AMG Care Collective*, *supra*.) Appellant has not done so here. Additionally, at the hearing, Mr. Mann testified that, among the reasons appellant closed, appellant's inability to deduct business expenses was "by far the biggest back breaker financially."[11] (Oral Hearing Transcript, p. 14.) Accordingly, we find appellant's final argument unpersuasive.

To summarize, we have examined CDTFA's audit procedures and computations, and found its determination reasonable and rational. In the absence of sufficient documentation or other evidence from which a more accurate determination may be made, we conclude that appellant has failed to meet its burden of showing that an additional reduction to the determined measure of tax is warranted.

[11] Businesses trafficking in controlled substances cannot deduct ordinary and necessary business expenses (see Internal Revenue Code, § 280E), and, under federal law, marijuana—which includes medical marijuana—is a controlled substance (see 21 U.S.C. § 812(c)(10)).

HOLDING

Appellant has not established that any further reduction to the determined measure of tax is warranted.

DISPOSITION

CDTFA's action in reducing the determined measure of tax to $601,591, deleting the negligence penalty, relieving the finality penalty, and otherwise denying the administrative protest and claim for refund is sustained.

DocuSigned by:
8A4294817A67463...
Andrew Wong
Administrative Law Judge

We concur:

DocuSigned by:
48745BB806914B4...
Josh Aldrich
Administrative Law Judge

DocuSigned by:
1A9B52EF88AC4C7...
Michael F. Geary
Administrative Law Judge

Date Issued: 4/1/2022