OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	OTA Case No.: 220710808
	CDTFA Case ID: 002-253-108
MARS & BEYOND CORPORATION	

OPINION

Representing the Parties:

For Appellant: Graham Hoad, Representative

For Respondent: Jason Parker, Chief of Headquarters Ops.

For Office of Tax Appeals: Craig Okihara, Business Taxes Specialist III

K. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6538.5, Mars & Beyond Corporation (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] partially denying appellant's July 22, 2020 application for an administrative hearing to protest a Notice of Jeopardy Determination (jeopardy determination).[2] The jeopardy determination is for a tax of $2,072,792.00, plus applicable interest, and a negligence penalty of $207,279.18, for the period April 1, 2017, through December 31, 2019 (liability period). CDTFA also imposed a finality

[1] Sales and use taxes were formerly administered by the State Board of Equalization (board). In 2017, functions of the board relevant to this case were 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 board.

[2] A petition for redetermination must be filed within 10 days along with payment of a security deposit, whereas an application for an administrative hearing must be filed within 30 days and does not require a payment. (R&TC, §§ 6538 [petition], 6538.5 [application for administrative hearing].)

penalty of $207,279.18 on August 3, 2020, pursuant to R&TC section 6537,[3] and a collection cost recovery fee of $950.00 on December 29, 2020, pursuant to R&TC section 6833.[4]

Pursuant to its decision, CDTFA performed a reaudit, which reduced the taxable measure from $27,552,150 to $22,549,346, and will result in a reduction to the determined tax, applicable interest, and penalties.

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

ISSUE

Whether additional adjustments to the amount of unreported taxable sales are warranted.

FACTUAL FINDINGS

1. Appellant operates a cannabis dispensary selling recreational and medical cannabis.
2. Appellant filed its Articles of Incorporation with the Secretary of State on April 20, 2015.
3. Appellant obtained a seller's permit with an effective date of May 8, 2015.
4. During the liability period, appellant was open seven days per week from 8:00 a.m. to 3:00 a.m. (i.e., 19 hours per day).
5. For the liability period, appellant filed sales and use tax returns reporting total sales of $704,268 and claiming deductions totaling $40,006 for sales tax reimbursement included, which resulted in reported taxable sales of $663,262.
6. Appellant did not provide any books and records for the audit.
7. Upon audit, CDTFA used the taxable sales that appellant reported on its sales and use tax returns to calculate reported average daily sales for each quarter and reported average hourly sales for each quarter. Based on the lack of records provided, CDTFA determined that additional investigation was warranted.

[3] The penalty was imposed because appellant did not either pay the liability, or file a petition for redetermination and pay the required security deposit, within the 10 days before it became final (finality penalty). (R&TC, §§ 6537, 6538.) CDTFA's jeopardy determination required payment of the entire liability as a security deposit.

[4] Appellant has not disputed the negligence penalty, finality penalty, or the CRF in its appeal here; thus, OTA does not discuss them further.

8. CDTFA performed the following outside observations of appellant's business:

   a. On Friday March 6, 2020, from 3:00 p.m. to 5:00 p.m. CDTFA observed 90 customers entering the business.

   b. On Monday March 9, 2020, from approximately 3:15 to 5:15 p.m. CDTFA observed 93 customers enter the business. [5]

   CDTFA counted each customer entering the business as a purchaser. Based on these two observations, CDTFA calculated an average of 46 purchasers per hour.

9. CDTFA multiplied the observed average number of purchasers per hour (46) by the number of hours that the business operated each day (19) and an estimated average sales price of $35 per customer (including sales tax reimbursement)[6] to calculate audited average daily sales of $28,103.[7] CDTFA then multiplied the average daily sales by the number of days in each month of the liability period and computed audited taxable sales of $28,215,412. CDTFA compared audited taxable sales to appellant's reported taxable sales and found unreported taxable sales of $27,552,150.

10. As relevant here, CDTFA noted its belief that "the business was in imminent danger of being shut down and all assets seized by law enforcement and/or regulatory agencies because it is operating in violation of local and/or state laws." CDTFA prepared a field billing order (FBO)[8] and issued the aforementioned jeopardy determination.[9]

11. Appellant filed a timely application for an administrative hearing on August 17, 2020.

12. On April 7, 2022, CDTFA issued a decision finding the following:

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[5] There is a conflict between CDTFA's decision and CDTFA's audit workpapers with regard to the timing of the March 9, 2020 observation. The decision indicates that CDTFA observed the business from 3:15 p.m. to 5:15 p.m. On the other hand, the audit workpapers indicate that CDTFA observed the business from 3:00 to 5:15 p.m. However, the schedules that tally the number of observed customers, reveals that CDTFA began its observation at 3:15 p.m. As such, OTA accepts that the observation began at 3:15 p.m.

[6] CDTFA estimated the average sales price based on its experience auditing other similar businesses in appellant's area.

[7] 19 hours per day × 46 customers per hour × ($35 ÷ (1 + 8.25 percent tax rate))

[8] The jeopardy determination was based on a field billing order (FBO) examination. CDTFA uses an FBO examination to recommend an additional tax liability using procedures that are not as comprehensive as those used in a regular audit. (CDTFA Audit Manual, §§ 0213.01, 0201.09.)

[9] Unlike a notice of deficiency determination, the amount in a jeopardy determination is immediately due and payable. (R&TC, § 6536.) A jeopardy determination may be issued when an amount of tax required to be paid to the state would be jeopardized by delay. (R&TC, § 6536.) In addition, a jeopardy determination becomes final if not paid, or petitioned with payment of a security deposit, within 10 days. (R&TC, §§ 6538, 6538.5.)

a. CDTFA used a recognized alternative method (observation test) to establish audited sales. However, CDTFA stated that "it seems apparent that the days and hours observed, taken as a whole, should be representative of the sales that [CDTFA] is attempting to calculate." Based on this, CDTFA found that the 4-hour total observation over two days was not sufficiently representative of the business operation. CDTFA then ordered a 5 percent reduction to the average number of customers per hour to account for the short observation test length.

b. CDTFA could not explain how it determined whether a person was a customer. CDTFA's decision noted that "the absence of records does not relieve [CDTFA] of its obligation to make the audit as accurate as possible." CDTFA's decision stated that the assumption that all customers entering a business made a purchase is unreasonable. Based on this, CDTFA ordered a further 10 percent reduction to the average number of customers per hour to account for people that entered the business but did not make a purchase.

c. CDTFA's decision also took issue with the application of the observation test to the entire liability period. Specifically, CDTFA noted that the observation test took place after the January 1, 2018 date where the sale and use of recreational cannabis became legal in California but the liability period included times before that date. CDTFA determined that it was likely that appellant's customer base grew substantially following the legalization of recreational cannabis. Therefore, CDTFA ordered a further 10 percent reduction to the average number of customers for the second quarter of 2017 (2Q17) through 4Q17 to account for the fact that recreational cannabis sales were not legal in California during this period. After application of these adjustments, CDTFA computed that appellant made 34 sales per hour for the period 2Q17 through 4Q17 and 39 customers per hour from 1Q18 through 4Q19.

Otherwise, CDTFA denied the application for administrative protest.

13. This timely appeal followed.

DISCUSSION

Issue 1: Whether additional adjustments to the amount of unreported taxable sales are warranted.

California imposes sales tax on a retailer's retail sales of tangible personal property sold in this state measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, §§ 6012, 6051.) For the purpose of the proper administration of the Sales and Use Tax Law and to prevent the evasion of the sales tax, the law presumes that all gross receipts are subject to tax until the contrary is established. (R&TC, § 6091.) It is the retailer's responsibility to maintain 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).)

Effective January 1, 2018, the sale in this state of, and the storage, use, or other consumption in this state of, medicinal cannabis or medicinal cannabis products as those terms are defined in Division 10 (commencing with Section 26000) of the Business and Professions Code are exempt from tax when a person with an identification card or primary caregiver furnishes the seller with both their card issued under section 11362.71 of the Health and Safety Code and a valid government-issued identification card. (R&TC § 6396.6.)[10]

If CDTFA is not satisfied with the amount of tax reported by the taxpayer, or in the case of a failure to file a return, CDTFA may determine the amount required to be paid on the basis of any information which is in its possession or may come into its possession. (R&TC, §§ 6481, 6511.) In the case of an appeal, CDTFA has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Talavera*, 2020-OTA-022P.) Once CDTFA has met its initial burden, the burden of proof shifts to the taxpayer to establish that a result differing from CDTFA's determination is warranted. (*Ibid*.) That means that the taxpayer must prove both: (1) the tax assessment is incorrect, and (2) the correct amount of the tax. (*Appeal of AMG Care Collective*, 2020-OTA-173P (*Appeal of AMG*).) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Talavera, supra*.)

Here, appellant did not provide any books and records for the audit. As such, CDTFA's decision to observe the business from outside, counting the number of people entering the dispensary, was reasonable and rational. (*Appeal of AMG*, *supra*.) Additionally, CDTFA's use

[10] Prior to June 30, 2022, the tax exemption was codified in R&TC section 34011(f).

of an estimated sales price based on audits of similar businesses in the area is both reasonable and rational.[11] However, CDTFA's observations require additional scrutiny because they totaled just four hours over the course of two days (a Monday and a Friday) at approximately the same time on each day. During CDTFA's own appeals process, CDTFA found that the 4-hour observation test was not sufficiently representative of the business, which was open 19 hours per day, 7 days per week. CDTFA also found that it was unreasonable to count every person that entered the business as a purchaser. Finally, CDTFA found that the absence of records did not relieve the obligation to perform an accurate audit. OTA agrees.

With that in mind, OTA notes the appearance of a potential conflict between CDTFA's decision in this case and OTA's Opinion in the *Appeal of AMG*, *supra*. In *Appeal of AMG*, OTA states that an observation test is a reasonable and rational audit method. *Appeal of AMG* also sets forth a taxpayer's burden of proof with respect to the audit liability. However, in that case, OTA found that it was reasonable to count every person entering the business as a purchaser during an observation test that covered several days and a variety of timespans. At first glance, this would appear to be in direct conflict with CDTFA's decision in this case, which considers a shorter observation test taking place at approximately the same time over the course of two days. Indeed, CDTFA concedes that in this case it is unreasonable to count every person that enters a business as a purchaser.

Nevertheless, OTA's Opinion in *Appeal of AMG* is not binding with respect to whether a particular audit is reasonable. OTA considers the facts and circumstances of each audit on a case-by-case basis. In the instant case, the observation test is distinguishable from the test considered in *Appeal of AMG*; the observation test here is for fewer hours, over less days, and each observation occurred at approximately the same time. As conceded by CDTFA, the observation test in this case is not representative of appellant's business. As such, OTA finds no conflict between the holdings in the *Appeal of AMG* and the conclusions herein.

Despite CDTFA's concessions regarding the observation test, it is also true that appellant failed to provide any books and records from which CDTFA could verify appellant's taxable sales. Further, CDTFA addressed the concerns raised by the short observation test by ordering a

[11] During its own appeals process, CDTFA presented articles to support the assertion that the average audited sales price was reasonable. For example, CDTFA provided research conducted by the California Agriculture Journal, which studied cannabis sales in 20 counties and found that the average price of cannabis flower ranged from $41.26 in August 2016 to $35.67. This evidence is strong support for the reasonable nature of CDTFA's estimated average sales price.

reaudit to reduce the audited average number of hourly sales. Upon reaudit, the average number of audited hourly sales was reduced by 15 percent for the liability period and an additional 10 percent for periods in which recreational cannabis could not be legally sold. This resulted in a $5,002,804 reduction to the deficiency measure from $27,552,150 to $22,549,346. Considering the complete lack of books and records, OTA find that CDTFA's observation test was reasonable and rational subject to the reductions calculated during the reaudit. Thus, the burden of proof shifts to the taxpayer to establish that a result differing from CDTFA's determination is warranted. (*Appeal of Talavera*, *supra*.)

On appeal, appellant argues that the deficiency measure must be reduced for several reasons. First, appellant argues that the audited average price per sale of $35 is overstated. Appellant argues that it sold items including edibles and vape pens for $8 to $10. Appellant also asserts that police surveilled the business, and stopped three customers, all of whom made purchases of 1 gram for $10. Additionally, appellant contends that it offered happy hour pricing. Thus, appellant asserts that the $35 estimated average sales price used in the audit is overstated.[12] Next, appellant asserts that its sales fluctuated throughout the day. Appellant argues that the observation tests occurred during the busiest time of day, when its customers were on their way from work.[13] Appellant relies on information obtained from Google[14] (Google data) to show that the business was less popular before 3 p.m. and after 12 a.m. Finally, appellant asserts that most of its sales were to exempt patients.

Initially, OTA notes that the Google data is evidence that sales fluctuated over time. However, the Google data is unreliable and incomplete because it does not account for those customers that did not participate in the Google Location History program. Even if the Google data was accurate, it reflects that the observation test did not occur during the busiest times of day. Thus, OTA finds that the Google data, on its own, is insufficient to support an adjustment

[12] CDTFA calculated its average sales price in ounces, estimating that the average sales amount to be one eighth ounce at $35 per eighth ounce. For equivalency, an eighth is roughly 3.5 grams. Thus, appellant's asserted price of $10 per gram is equivalent to $35 for 3.5 grams (one eighth ounce.) CDTFA's estimated average sales price is also consistent with the study published by the California Agriculture Journal, which listed prices by ounce.

[13] Appellant contends that most of its customers are agricultural, oil, and manufacturing employees that work from 6:00 a.m. to 3:00 p.m.

[14] Google aggregates data from users that opt into its "Google Location History" program to track popular times, wait times, and visit duration for a business. Google Location History is turned off by default in a Google account and can only be turned on if a user opts into the program. Users may choose to delete all or part of their Google Location History.

to the taxable measure. By comparison, CDTFA conducted a reaudit to account for the number of days, time periods in which the observation occurred, and total length of the observation period. CDTFA also reduced the taxable measure to account for people that entered the business and did not make a purchase. CDTFA's adjustments reasonably and rationally account for fluctuations in the business.

Appellant also has not provided any substantiation for the claims that the average sales price should be reduced. For example, appellant asserts without evidence that police stopped customers that made $10 purchases. Appellant also has not provided any evidence of happy hour pricing. Appellant's unsupported assertions are not sufficient to meet its burden of proof. (*Appeal of Talavera*, *supra*.) Further, even if some customers did make $10 purchases, it is also likely that some customers made purchases of more than $35. Accordingly, OTA rejects the contention that the audited average sales price should be reduced. [15]

Finally, appellant asserts that most of its sales were exempt sales of medicinal marijuana. However, during the liability period, appellant did not claim any exempt sales of medical marijuana on its sales and use tax returns. Additionally, appellant has not provided any evidence that it made medical marijuana sales, such as copies of medical marijuana identification cards. Appellant's unsupported assertions are insufficient to meet their burden of proof. (*Appeal of Talavera*, *supra*.)

In summary, OTA finds that CDTFA computed audited taxable sales based on the best-available evidence. Appellant has not identified any errors in CDTFA's computation of audited taxable sales (in the reaudit) or provided new documentation or other evidence in support of its contentions from which a more accurate determination could be made. As appellant bears the burden of proof in this case, OTA must conclude that no adjustments are warranted.

[15] A 15 percent cannabis excise tax applies to purchases of cannabis or cannabis products sold in this state during the period January 1, 2018, through January 1, 2023, a cannabis retailer is required to collect this from the purchaser, and this amount is subject to sales tax. (See R&TC § 34011.) While the cannabis excise tax is not at issue in this case; the fact that the excise tax is included in a retailer's gross receipts and required to be collected from the purchaser would suggest that, contrary to appellant's position, appellant's gross receipts should be *increased* for periods on and after January 1, 2018.

HOLDING

Appellant has not shown that further adjustments to the measure of tax are warranted.

DISPOSITION

CDTFA's action in recommending that the determined measure of tax be reduced from $27,552,150 to $22,549,346 as computed in CDTFA's reaudit, but otherwise denying the application for an administrative hearing, is sustained.

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Keith T. Long
Administrative Law Judge

We concur:

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Josh Aldrich
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Josh Aldrich
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