DocuSign Envelope ID: 42CD1A13-CB64-4097-89A6-ADE141922E3D

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **SACRAMENTAL NATIVE AMERICAN CHURCH, dba S.N.A.C.**	OTA Case No. 220510338 CDTFA Case ID: 02-442-975

OPINION

Representing the Parties:

For Appellant: Jeffrey B. Kahn, Attorney

For Respondent: Jason Parker, Chief of Headquarters Operations

For Office of Tax Appeals: Deborah Cumins, Business Taxes Specialist III

A. KWEE, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6538.5, Sacramental Native American Church dba S.N.A.C. (appellant)[1] appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA).[2] CDTFA's decision denies, in part, appellant's timely application for an administrative hearing to protest a Jeopardy Notice of Determination (jeopardy determination) issued on December 15, 2020.[3] The jeopardy determination is for tax of $239,336.00, applicable interest, and a failure-to-file penalty of $23,933.60, for the period May 7, 2018, through September 30, 2020.

[1] Effective May 14, 2019, appellant changed its name from "Sacrament Collective Pentecostal Church" to "Sacramental Native American Church."

[2] 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.

[3] A petition for redetermination of a jeopardy determination must be filed within 10 days along with payment of the security, 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].)

DocuSign Envelope ID: 42CD1A13-CB64-4097-89A6-ADE141922E3D

Pursuant to R&TC section 6537, CDTFA assessed a finality penalty of $23,933.60 on December 28, 2020.[4] On March 23, 2021, CDTFA assessed a collection cost recovery fee (CRF) of $950.00 pursuant to R&TC section 6833, to cover costs incurred for collection of the unpaid liability.

On appeal, CDTFA concedes to reducing the amount of tax to $163,281.00, representing taxes due for the period September 1, 2018, through September 30, 2020 (liability period). This will result in corresponding reductions to the 10 percent failure-to-file and finality penalties (to $16,328.12 each). Appellant waived the right to an oral hearing; therefore, the matter is being decided based on the written record.

ISSUES[5]

1. Whether sales tax applies to the disputed cannabis transactions.
2. Whether appellant has established that further adjustments are warranted to the amounts of unreported taxable sales.
3. Whether appellant has shown reasonable cause to relieve the failure-to-file penalty or the finality penalty.
4. Whether appellant has shown reasonable cause to relieve the CRF.

FACTUAL FINDINGS

1. Appellant registered with the California Secretary of State (SOS) on May 7, 2018, as a Nonprofit Religious Corporation. Appellant reported to the California SOS that it is organized and operated for religious purposes within the meaning of Internal Revenue Code section 501(c)(3).

---

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

[5] In its opening brief, appellant argues that CDTFA, in conjunction and concert with the California Bureau of Cannabis Control as well as various local agencies, has targeted the Sacramental Native American Church based on its religious beliefs. This appeal with the Office of Tax Appeals (OTA) is not the venue for that argument. The purpose of an appeal with OTA is to determine whether CDTFA has established the correct amount of taxable sales. (Cal. Code Regs., tit. 18, § 30104(d); see *Appeal of Eichler*, 2022-OTA-029P.) Therefore, OTA will not address appellant's assertion that it has been unfairly targeted.

DocuSign Envelope ID: 42CD1A13-CB64-4097-89A6-ADE141922E3D

2. In filings with the California SOS, appellant reported the purposes of the corporation as religious worship, spiritual teaching, and the Medicinal and Adult-Use Cannabis Regulation and Safety Act (MAUCRSA).[6]
3. According to the records of the Franchise Tax Board, appellant was an entity exempt from taxes imposed under Part 11 of the R&TC, because appellant was a corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes. (See R&TC, § 23701d.)
4. According to a Standard Multi-Tenant Office Lease (Lease Agreement) provided by appellant, on August 1, 2018, appellant entered a five-year real property lease for the business premises where it operated. The monthly rent was $2,050 starting August 1, 2018, and increased every 12 months thereafter based on a fixed rental adjustment schedule in the Lease Agreement until the lease expiration date (August 1, 2023). The Lease Agreement granted possession of the premises on August 1, 2018, and the agreed use of the premises was as a church.
5. Appellant did not hold or obtain any licenses issued by the State of California to operate as a cannabis business.
6. On or about September 1, 2018, appellant began operating as an unlicensed retailer of cannabis products.[7] During the liability period, appellant distributed cannabis and cannabis-related products to its patrons during open hours.
7. Appellant was open to the public starting at 11:30 a.m., every day of the week. Appellant closed at 7 p.m. on Saturdays through Thursdays, and 8 p.m. on Fridays.
8. On February 18, 2020, CDTFA visited appellant's location. Appellant was not open during the observation (from 10:00 – 10:30 a.m.). CDTFA observed that appellant's business was located at the back of the building, and appellant had a private entrance that was not shared or used by customers for any other businesses in the building. Several video cameras were installed on the business premises. In addition, there was a doorbell with a built-in camera and a note on the door, stating "Press the doorbell and wait for the sound to unlock the door."

---

[6] MAUCRSA sets up a basic framework for licensing, oversight, and enforcement related to cannabis businesses. (See Assembly Bill No. 133 (Stats. 2017, Ch. 253) and Senate Bill 94 (Stats. 2017, Ch. 27).)

[7] Appellant failed to obtain the required license with the California Bureau of Cannabis Control (now the Department of Cannabis Control) to sell cannabis products in this state. (Bus. & Prof. Code, §§ 26012, 26037.5.) In 2021, after the liability period, the Department of Cannabis Control succeeded to, and was vested with the duties, powers, and jurisdiction of, the California Bureau of Cannabis Control. (Bus. & Prof. Code, § 26010.7.)"

DocuSign Envelope ID: 42CD1A13-CB64-4097-89A6-ADE141922E3D

9. On March 6, 2020, CDTFA observed 54 individuals entering appellant's business during two observation periods (from 11:30 a.m. to 1:30 p.m., and from 2:00 p.m. to 4:00 p.m.). CDTFA observed individuals leaving appellant's premises carrying red bags or brown bags.
10. On March 6, 2020, after the second two-hour observation period that day, CDTFA staff entered the business but, after identifying themselves, were asked to step outside and were denied re-entry.
11. On April 9, 2020, CDTFA sent a letter to appellant informing appellant that it was operating a business that sells cannabis and/or cannabis products and was required to register for a permit, file returns, maintain records, and pay sales and use and cannabis excise taxes. CDTFA gave appellant 14 days to register for a seller's permit.
12. Appellant did not apply for a seller's permit and has not filed any sales and use tax returns.
13. CDTFA issued a seller's permit or account number to appellant with an effective start date of May 7, 2018. In response, appellant filed a Form CDTFA-65, Notice of Closeout, for this account number, dated May 7, 2018. Appellant reported that it was "not a business," and that it did not make any sales, and requested the closeout of the account as of the effective date.
14. CDTFA conducted an audit of appellant for the liability period.
15. Appellant provided no books and records for audit. Instead, appellant contended that it is a church and churches are tax-exempt. Appellant further claimed that it received voluntary donations and provided cannabis as part of a religious sacrament, and that it had an ordained minister named Corinna.
16. In the absence of records, CDTFA reviewed information regarding appellant on Yelp.com (Yelp).[8] From that information, CDTFA identified a website for appellant.[9] Appellant's website included detailed pictures of cannabis products, along with detailed and incremental selling prices. Appellant sold cannabis indica, sativa, hybrid, and concentrate products in exchange for a "donation." Appellant offered each cannabis product for sale in different varieties. For example, appellant sold "Holy Grail OG," a

[8] Yelp.com is a social networking site on which users post reviews and rate businesses.

[9] https://ofpeacechurch.wixsite.com/mysite/indica

DocuSign Envelope ID: 42CD1A13-CB64-4097-89A6-ADE141922E3D

product produced from a cannabis indica plant, in the following increments: 1/8 ($30), 1/4 ($60), ½ ($115), 1oz ($225).

17. In pertinent part, appellant's price list also included the following cannabis concentrate products for sale: Gorilla Glue Shatter ($10/1g), Banjo crumble ($20/1g), Blackjack x SFV OG crumble ($20/1g), Thin Mint crumble ($20/1g), and Strawberry Banana Butter ($15/1g).

18. After noting the above products, CDTFA examined the Yelp reviews of appellant's business. The two recommended reviews read as follows (typographical errors are included in the original text):

> [First Yelp review.] I came here a few days ago because a friend had told me this place had good tree. But i was more than happy to see my last bosses i worked for, honestly they have great choices on Crumble and Shatter, for 20-35 donation. And compared to other dispensaries the Wax Prices are amazing, im glad they still keep it compassionate for everyone if they are struggling. Id definetly check them out. Place is super small so try going in alone. Room only fits 1 patient at a time. Bud wise, i rarely smoke weed but i hear the weed is good too, im just more into concentrates.
>
> [Second Yelp review.] I used to enjoy coming here to get flowers, I loved the prices up until quite recently. This past month I have had issues with a woman who works there, i believe her name is Karina. Not only is she not giving me the amount of product, but she is also not returning my change after purchase as well as constantly changing the prices . . . I used to frequent this place, now it's just not the same.

19. Based on the information contained on appellant's own website, as corroborated by reviews posted on Yelp, CDTFA concluded that appellant was selling cannabis to patrons. CDTFA used the information from appellant's website to compute an average price of $23 for 1/8 ounce of flower.

20. CDTFA increased the estimated average selling price to reflect: (1) a 10 percent business tax assessed by the City of San Jose on sales of cannabis products and (2) a 15 percent California excise tax on cannabis sales. After those adjustments, the audited selling price is $29 for 1/8 ounce of flower.

21. Based on appellant's business hours, CDTFA determined that appellant was open 53.5 hours each week. Based on observing 54 customers enter the business during the

DocuSign Envelope ID: 42CD1A13-CB64-4097-89A6-ADE141922E3D

four hours of observation, CDTFA computed that appellant had 13.5 customers make a purchase per hour. CDTFA then computed quarterly sales of $269,399.[10]

22. On December 15, 2020, CDTFA issued the jeopardy determination to appellant. CDTFA concluded that a jeopardy determination was necessary because appellant was operating without licenses, and CDTFA determined that the assets of the business would be easily dissipated. CDTFA concluded that any further delay in collection activity would seriously jeopardize CDTFA's ability to collect the amounts due.[11]

23. On December 24, 2020, appellant timely filed an application for an administrative hearing for the following purposes: (1) to establish that the jeopardy determination is excessive; (2) to request the release of the seized property; and (3) to request a stay of collection activities.

24. CDTFA began collection actions, and on February 12, 2021, 348 items of various untaxed and unsecured packaging of cannabis or cannabis products were seized from appellant.

25. On March 23, 2021, CDTFA issued a Notice of Collection Fee, assessing a CRF of $950 because the liability shown in its December 22, 2020 Demand for Immediate Payment remained unpaid.[12]

26. On August 5, 2021, CDTFA held an administrative hearing regarding the jeopardy determination.

27. On January 31, 2022, CDTFA issued a Decision ordering a reaudit to reduce the audited number of customers per hour by 10 percent, which included a 5 percent reduction to account for concerns that the observation test provided incomplete data and a 5 percent reduction to account for individuals who entered the business but did not make a purchase.

---

[10] OTA computes a slightly higher figure (53.5 hours per week x 13.5 customers per hour x $29.00 average sale x 13 weeks per quarter). While there appears to be a difference due to rounding, this is moot because of adjustments CDTFA made to this calculation during the reaudit.

[11] 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.)

[12] The Demand for Immediate Payment and the Notice of Collection Fee are not in the record.

28. In a March 10, 2022 letter to appellant, CDTFA stated that it had conducted a reaudit that reduced the tax from $219,336 to $217,127. CDTFA made corresponding adjustments to the 10 percent failure-to-file and finality penalties.
29. On March 23, 2022, appellant filed a timely appeal with the Office of Tax Appeals (OTA).
30. On appeal, CDTFA concedes to additional adjustments. CDTFA deleted the 10 percent City of San Jose Business Tax from the computation of the estimated average sale amount from $29.00 to $26.09 because it concluded that the selling prices used to compute the average price of $23.00 for 1/8 ounce of flower included the San Jose tax. In addition, CDTFA deleted the liability for the period May 7, 2018, through August 31, 2018, on the basis that appellant did not start operating until September 1, 2018. Finally, CDTFA concluded that appellant's sales would not have been constant for the entire liability period. CDTFA estimated a growth rate of 2.5 percent per quarter. CDTFA computed audited taxable sales of $220,493.00[13] for the first quarter 2020, when the observation was performed. It then increased the sales by 2.5 percent in its computation of audited sales for the second and third quarters of 2020. For periods before the first quarter 2020, CDTFA decreased audited sales by 2.5 percent for each quarter. In summary, applying the above concessions, CDTFA now asserts a taxable measure of $1,765,206.00 for the liability period, representing tax of $163,281.00.

DISCUSSION

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 purposes of the proper administration of the Sales and Use Tax Law and to prevent the evasion of the sales tax, the law presumes that all gross receipts are subject to tax until the contrary is established. (R&TC, § 6091.) It is the retailer's responsibility to maintain complete and accurate records to support

[13] 54 customers in 4 hours less 10 percent = 48.60, or 12.15 per hour. 12.15 customers per hour x 53.50 hours per week = 650 customers per week and 8,450 customers in a 13-week quarter. 8,450 x $26.0935 = $220,490.00. The minor difference is due to rounding of the other elements of the computation.

reported amounts and to make them available for examination. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)1).)

When 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*.) The applicable burden of proof is by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(c); *Appeal of Estate of Gillespie*, 2018-OTA-052P.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid*.)

Issue 1: Whether sales tax applies to the disputed cannabis transactions.

A retailer includes every seller who makes any retail sale of tangible personal property. (R&TC, § 6015(a)(1).) A sale is any transfer of title or possession, exchange, or barter, conditional or otherwise, in any manner or by any means whatsoever, of tangible personal property for a consideration. (R&TC, § 6006.) A retail sale means a sale of tangible personal property for a purpose other than resale in the regular course of business.

Here, appellant posted selling prices for cannabis on its website. Evidence that appellant charged selling prices for the advertised cannabis products is corroborated by the Yelp reviews and the personal observations of CDTFA's investigators when they visited appellant's location. As such, the facts demonstrate that appellant transferred title and possession to cannabis in exchange for an advertised consideration paid in United States currency. Furthermore, with respect to appellant's contention that the payments were voluntary donations, the facts demonstrate that transfer of the indica was contingent on payment of the consideration. Regardless of whether appellant or the customer refer to the consideration paid as a "donation," "tithe," or otherwise, this is the very definition of a sale. (R&TC, § 6006.) As such, appellant was a retailer of cannabis products. Although appellant contends that it provided cannabis products as a sacrament, appellant required payment of an advertised "donation" amount in exchange for the cannabis and CDTFA observed appellant's patrons leaving appellant's business

location carrying red or brown bags. All of these facts clearly support a conclusion that the transactions were sales pursuant to R&TC section 6006.

There is no exclusion from gross receipts for sales made by a charitable organization. (R&TC, §§ 6011, 6012.) As a limited exemption, certain sales by a charitable organization are exempt from tax provided certain conditions are met. (Cal. Code Regs., tit. 18, § 1570.) The law provides, in pertinent part, that sales by a charitable organization are exempt from tax provided: (1) the organization is formed and operated for charitable purposes and qualifies for the welfare exemption provide by R&TC section 214; (2) the organization is engaged in the relief of poverty and distress; (3) the organization's sales or donations are made principally as a matter of assistance to purchasers or donees in distressed financial condition; (4) the property must have been made, prepared, assembled, or manufactured by the organization.

First, in order to receive the sales tax exemption, it is necessary for the organization to receive the welfare exemption on the retail location for which the seller's permit is held. (Cal. Code Regs., tit. 18, § 1570(a)(4)(B).) Here, appellant did not hold a seller's permit and there is no evidence or contention that it claimed the welfare exemption with the county assessor.

Second, there is no evidence or contention that appellant's primary purpose is to relieve poverty and distress and that appellant sold property at reduced prices or donated its property so as to be of real assistance to indigent customers. (Cal. Code Regs., tit. 18, § 1570(a)(4)(C).)

Based on the above, OTA finds that tax applies to appellant's sales of cannabis products.

<u>Issue 2: Whether appellant has established that further adjustments are warranted to the amounts of unreported taxable sales</u>.[14]

Here, appellant failed to maintain or provide any records to support reported amounts, as required by law. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)1).) Instead, appellant refused to cooperate with CDTFA. In absence of supporting documentation from appellant, CDTFA computed an estimated liability based on three factors: (1) an estimated average purchase amount per patron based on CDTFA's experience with comparable businesses;

[14] In its appeal with CDTFA, appellant argued that its business closed around February 2020, about seven months before the end of the liability period. In its January 31, 2022 Decision, CDTFA rejected that argument because it found that appellant had filed an updated Statement of Information on the California Secretary of State's website on November 22, 2020. CDTFA also noted that significant amounts of cannabis products were seized from appellant's premises on February 12, 2021. Accordingly, the available evidence indicates that appellant was operating after the end of the liability period, and that issue will not be addressed further herein.

(2) an estimated number of patrons per hour based on CDTFA's observations of appellant's business; and (3) the number of hours the business operated based on information provided to or obtained by CDTFA. In a different appeal involving a cannabis dispensary that failed to maintain or provide adequate records, OTA previously concluded the above approach (three-factor method) was reasonable and rational. (*Appeal of AMG Care Collective*, 2020-OTA-173P.) As such, OTA finds that using this three-factor method to estimate taxable sales (based on patrons observed per hour, an average estimated purchase price, and hours of operation) is a reasonable and rational method for purposes of meeting CDTFA's initial burden to establish underreported taxable sales by the cannabis dispensary in absence of available records.

CDTFA also made some additional facts and circumstances-based adjustments to the three-factor method which were not made in *AMG Care Collective*, *supra*.

First, CDTFA also allowed a downward adjustment of 10 percent to the observed number of patrons per hour to account for factors such as that not every patron would make a purchase.

Second, CDTFA accounted for revenue growth and made projected increases to taxable sales following the observation period, and decreases for the quarters leading up to the observation period, because this was a new business. These adjustments consider that, while the three-factor method is a reasonable and rational approach taken in cannabis retailer audits when sufficient documentation is not available, the facts and circumstances may warrant additional adjustments to the three-factor method. OTA finds these adjustments reasonable and rational.

Third, for reporting periods starting January 1, 2018, CDTFA utilized an estimated average quarterly sales amount that accounted for the 15 percent cannabis excise tax imposed effective January 1, 2018, on purchasers of cannabis products sold in this state. (R&TC, § 34011(a).) The cannabis retailer is responsible for collecting this tax from the purchaser, and a cannabis distributor collects it from the cannabis retailer. (R&TC, § 34011(b).) A cannabis retailer may separately state a charge for the cannabis excise tax when the cannabis products are sold to a purchaser, equal to the cannabis excise tax required to be paid to the cannabis distributor. (Cal. Code Regs., tit. 18, § 3700.) This 15 percent cannabis excise tax is subject to sales tax. (R&TC, § 34011(d).) The 15 percent cannabis excise tax was not applicable in *Appeal of AMG Care Collective*, *supra*, because that appeal only included reporting periods prior to January 1, 2018. It is reasonable and rational to infer that appellant's distributor would collect a statutorily required excise tax from appellant, and that appellant would in turn collect such

DocuSign Envelope ID: 42CD1A13-CB64-4097-89A6-ADE141922E3D

amounts from its customers, as required by R&TC section 34011(b)(1), to reimburse the costs appellant paid to its distributor. Therefore, OTA finds it was reasonable and rational for CDTFA's estimate of unreported taxable sales to account for the 15 percent excise tax.

In summary, use of the three-factor method, including the above summarized facts and circumstances-based adjustments, was reasonable and rational. Accordingly, appellant has the burden of establishing that adjustments are warranted.

Appellant argues that the audited amount of taxable sales is overstated because (1) not every person observed entering the premises made a purchase, and because (2) CDTFA only performed one day of observation. Nevertheless, appellant provided no books and records to support an alternative calculation. Moreover, appellant did not cooperate with CDTFA during the audit and did not provide any information from which CDTFA could determine a more accurate measure for the unreported taxable sales. This Opinion discusses both of appellant's contentions, in turn.

Individuals entering the business and not making a purchase

During its observations of the business, CDTFA remained outside and counted the number of patrons who entered the building. For purposes of calculating the underreporting, CDTFA determined that each patron made, on average, a $26.09 purchase.

Appellant contends that an allowance is warranted for patrons who did not make a purchase. CDTFA's Decision already conceded a 5 percent allowance is warranted on this basis, so OTA understands appellant to be contending that a greater allowance is warranted.

As a general matter, the taxpayer bears the burden of proof with respect to establishing an adjustment, and unsupported assertions are not sufficient to meet this burden. (R&TC, § 6091; *Appeal of Estate of Gillespie*, *supra*.) In the instant case, CDTFA estimated the liability based on an audit assumption that every patron made a $26.09, on average, purchase. Appellant contends that not every patron made a purchase.

CDTFA observed 54 people enter the premises over a period of 4 hours. CDTFA did not actually observe a single patron make a purchase from appellant because appellant did not permit entry to CDTFA's investigators. Additionally, CDTFA did not distinguish between patrons exiting the building with or without property, such as paper bags in their hands, or patrons entering in groups versus singly.

DocuSign Envelope ID: 42CD1A13-CB64-4097-89A6-ADE141922E3D

CDTFA's audit and policy manuals provide useful information on accepted audit procedures and policies which OTA may look to for guidance. (*Appeal of Micelle Laboratories*, 2020-OTA-290P.) CDTFA does not have specific published policies or procedures in the case of auditing or observing a cannabis dispensary. However, for markup audits CDTFA's Audit Manual acknowledges that, when common issues are present, standard allowances are appropriate without complete justification for a specific dollar amount. CDTFA's Audit Manual provides that when CDTFA conducts an audit using the markup method, standard allowances of up to 3 percent of cost for self-consumption, and 1 percent of cost for shrinkage, are allowable when these items are present, without complete justification for a specific dollar amount. (CDTFA Audit Manual, § 0407.10.) While the instant case does not involve a markup audit, it is relevant to note that CDTFA's audit policies and procedures acknowledge there are circumstances where standard allowances are appropriate without complete documentation.

OTA finds that a 5 percent allowance is reasonable and rational, and it is consistent with the above audit guidance. Furthermore, in absence of supporting documentation, there is no basis to provide a greater allowance.

The Observation Test

Appellant raises concerns about the length of the observation test, which was only four hours over the course of a single day. Appellant contends that traffic was higher during the observation test period because it was sunny, and it was a Friday. Appellant argues that it is inappropriate to conclude that the results of the one-day test is representative of sales during the entire liability period.[15] CDTFA's Decision conceded a 5 percent allowance to address concerns with the completeness of the observation test. As such, OTA understands that appellant is asking for a greater allowance.

Regarding the assertion that some of the individuals counted as customers may have been going to a different business, CDTFA's records indicate that CDTFA observed that appellant's business had a separate entrance and sign. Thus, the facts support that CDTFA was able to identify the patrons who were entering and exiting appellant's business. Appellant offered no evidence to the contrary. Regarding appellant's comment about the weather, appellant's

[15] Appellant also contends that it never received a final audit report before CDTFA pursued collection activities. OTA lacks jurisdiction to address remedies for the manner in which CDTFA pursued collection activities. (See Cal. Code Regs., tit. 18, § 30104(d).)

business is located indoors, and appellant presented no evidence to support that the number of patrons of appellant's cannabis dispensary varies depending on the weather.

Regarding appellant's concern about the length of the test, four hours of observation is less than the minimum time established by section 0810.30 of CDTFA's Audit Manual,[16] which recommends three full observation days to project sales for audits of bars and restaurants.[17] However, for several reasons, OTA does not find that the audit results should be disregarded, or even adjusted further, on that basis alone. This alternative methodology was necessary because appellant did not provide verifiable records for audit. According to CDTFA's activity history, which is part of the audit workpapers, appellant refused CDTFA's requests for records on the basis that it was not making any sales. Appellant also did not participate in the audit process and never requested that additional testing be conducted.

CDTFA's observations included only hours on a Friday; specifically, the first two hours of appellant's business day, 11:30 a.m. to 1:30 p.m., and two hours in the afternoon, 2:00 p.m. to 4:00 p.m. There is no evidence that customer traffic would have been unusually high during those times. Further, more customer traffic would generally be expected in the evenings and on weekends. Finally, CDTFA's Audit Manual does not necessarily represent the minimum threshold for establishing a reasonable and rational basis for a determination. Under the facts presented here, appellant's assertion that the test is unrepresentative is not sufficient to disregard the test. Instead, it is incumbent on appellant to prove a more accurate result. (*Appeal of AMG Care Collective*, *supra*.)

As noted previously, CDTFA has adjusted the audited number of customers per hour by reducing the number observed for the four-hour period by a total of 10 percent. CDTFA has also adjusted the audited sales for a 2.5 percent quarterly increase in sales. CDTFA provided data regarding the growth of the California marijuana industry, which reflects an average increase of 4.59 percent per year from 2018. Thus, CDTFA's estimate of growth for appellant, which represents 10 percent per year, appears to be reasonable, if not generous. CDTFA's adjustments

---

[16] CDTFA's Audit Manual "is an advisory publication providing direction to [CDTFA] staff administering the Sales and Use Tax Law and Regulations." OTA is not required to follow CDTFA's Audit Manual; however, OTA may look to it for guidance, such as when evaluating the reasonableness of CDTFA's determination. (*Appeal of Micelle Laboratories, Inc*., *supra*.)

[17] The Audit Manual language regarding observation testing is in Chapter 8, entitled "Bars and Restaurants." Thus, it does not apply specifically to cannabis dispensaries and is instead cited here as guidance that OTA may consider when evaluating the reasonableness of the methods chosen by CDTFA.

for quarterly growth fully address appellant's assertion that the results of the test were not applicable to the entire liability period.

Again, it is noted that appellant has not provided any evidence that CDTFA could use to establish a more reliable audited measure of taxable sales. In summary, appellant has not established that further adjustments are warranted to the audited amount of unreported taxable sales.

Issue 3: Whether appellant has shown reasonable cause to relieve the failure-to-file penalty or the finality penalty.

If a person fails to make a return, CDTFA shall make an estimate of the tax required to be paid to the state, adding to the sum determined a penalty equal to 10 percent thereof (commonly known as a failure-to-file penalty). (R&TC, § 6511.) If the amount of a jeopardy determination is not paid within 10 days after service of notice, the amount becomes final at the expiration of the 10 days, unless a petition for redetermination (including the required payment of security) is filed within 10 days, and the 10 percent penalty provided in R&TC section 6591 is applied. (R&TC, §§ 6537, 6538.) This penalty is commonly called a finality penalty.

Relief of the failure-to-file and finality penalties may be granted where the failure to file the return or make a timely payment was due to reasonable cause and circumstances beyond its control, and occurred notwithstanding the taxpayer's exercise of ordinary care and in the absence of willful neglect. (R&TC, § 6592(a).) A taxpayer seeking relief from such a penalty must file a statement signed under penalty of perjury setting forth the facts upon which the request for relief is based. (R&TC, § 6592(b).)

Regarding the failure-to-file penalty, appellant did not obtain a seller's permit and has filed no sales and use tax returns. Therefore, CDTFA applied a 10 percent failure-to-file penalty to the jeopardy determination.

Regarding the finality penalty, appellant filed a protest of the jeopardy determination within ten days of the date the jeopardy determination was issued, but appellant did not deposit security with CDTFA. Accordingly, the determination became final, and a finality penalty was applied.

Appellant has filed a written request for relief of the penalties. Appellant has offered three reasons for its request. First, appellant claims the jeopardy determination is excessive.

Second, appellant notes that the jeopardy determination is currently being appealed. Third, appellant states that it was not afforded due process to contest the assessment.

Regarding appellant's first basis, OTA has previously found that no further adjustments are warranted to the jeopardy determination. Thus, appellant's assertion that the jeopardy determination is excessive is not a basis for relief.

Appellant's second basis is that the jeopardy determination is being appealed. Appellant has not explained how its appeal of the jeopardy determination resulted in its failure to file sales and use tax returns long before the jeopardy determination was issued. Regarding the finality penalty, it is explained above that, in order for an appeal to prevent the application of the finality penalty with respect to a jeopardy determination, the appellant must deposit security with CDTFA, which appellant did not do.

Appellant's third basis is that it was not afforded the opportunity to protest the assessment. Nothing has prevented appellant's right to protest the liability, and appellant is, in fact, protesting the liability.

None of appellant's stated reasons for its request for relief from the penalties offers reasonable cause for its failure to timely file sales and use tax returns or for its failure to pay the jeopardy determination. Accordingly, appellant has provided no basis for relief from the penalties.

<u>Issue 4: Whether appellant has shown reasonable cause to relieve the CRF.</u>

The CRF is imposed on any person who fails to pay an amount of tax, interest, penalty, or other amount that is due and payable under the Sales and Use Tax Law. The CRF shall be imposed only if CDTFA has mailed its demand notice to the person for payment, advising that continued failure to pay the amount due may result in collection action, including the imposition of a CRF. (R&TC, § 6833(a).)

If it is determined that the person's failure to pay was due to reasonable cause and circumstances beyond the person's control, and occurred notwithstanding the exercise of ordinary care and the absence of willful neglect, the person shall be relieved of the CRF. (R&TC, § 6833(d).) Any person seeking to be relieved of the CRF shall file a statement under penalty of perjury setting forth the facts upon which the person bases the claim for relief. (R&TC, § 6833(d).)

DocuSign Envelope ID: 42CD1A13-CB64-4097-89A6-ADE141922E3D

On December 22, 2020, CDTFA issued a Demand for Immediate Payment notice to appellant. On March 23, 2021, CDTFA issued a Notice of Collection Fee, assessing a CRF of $950 because the liability remained unpaid.

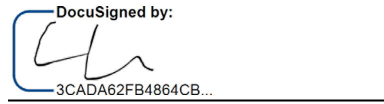
On the same form with its request for relief of the penalties, appellant also requested relief of the CRF, offering the same three reasons. As expressed above regarding the request for relief of penalties, none of appellant's stated reasons for requesting relief establishes reasonable cause for appellant's failure to pay the final liability. Thus, since appellant has not shown that its failure to pay the final liability was due to reasonable cause, there is no basis for relief of the CRF.

HOLDINGS

1. Sales tax applies to the disputed cannabis transactions.
2. Appellant has not established that further adjustments are warranted to the amounts of unreported taxable sales.
3. Appellant has not shown reasonable cause to relieve the failure-to-file penalty or the finality penalty.
4. Appellant has not shown reasonable cause to relieve the CRF.

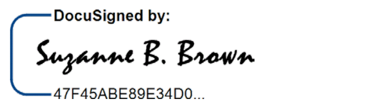
DISPOSITION

The tax liability shall be reduced to $163,281.00, as conceded by CDTFA. In addition, corresponding reductions shall be made to the 10 percent failure-to-file and finality penalties (which should reduce them to approximately $16,328.12 each). CDTFA's action is otherwise sustained.

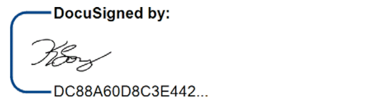


Andrew J. Kwee
Administrative Law Judge

We concur:



Suzanne B. Brown
Administrative Law Judge



Keith T. Long
Administrative Law Judge

Date Issued: 3/23/2023