OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **MELROSE FACILITY MANAGEMENT, LLC**	OTA Case No.: 240817001 CDTFA Case ID: 4-109-526

OPINION

Representing the Parties:

For Appellant: James Han, CPA

For Respondent: Jennifer Barry, Attorney

M. GEARY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Melrose Facility Management, LLC (appellant) appeals a decision[1] issued by the California Department of Tax and Fee Administration (respondent) denying, in part, appellant's petition for redetermination of an August 5, 2022 Notice of Determination (NOD) for tax of $877,844.22, plus applicable interest, and a penalty of $438,922.11 for the period March 22, 2019, through March 31, 2022 (liability period).[2] A subsequent reaudit reduced the tax to $738,367.85 and the penalty to $369,183.93.

Appellant waived the right to an oral hearing and submitted the matter to the Office of Tax Appeals (OTA) on the written record pursuant to California Code of Regulations, title 18, (Regulation) section 30209(a).

[1] Respondent issued a decision and a supplemental decision, which were to the same effect. This Opinion uses the singular for ease of reference.

[2] The NOD was timely issued within the three-year statute of limitations for the period July 1, 2019, through March 31, 2022. (R&TC, § 55062.) It was also timely issued for the second quarter of 2019 (2Q19) because on May 11, 2022, appellant's representative signed a waiver of the three-year statute of limitations allowing respondent until September 11, 2022 to issue an NOD for the period March 11, 2019, through March 31, 2019. (R&TC, § 55064.) However, because a waiver is valid only for periods not already expired when the waiver is signed, and because OTA finds no evidence that the taxes for 1Q19 were due, or that appellant's return for 1Q19 was filed, within the three years prior to May 11, 2022, the NOD is barred by the statute of limitations for 1Q19. Nevertheless, because respondent did not determine a liability for 1Q19, the barred period has no impact on appellant's liability.

ISSUE

Is appellant entitled to relief from the failure-to-pay penalty?

FACTUAL FINDINGS

1. Appellant has been a registered cannabis distributor since March 22, 2019, and the holder of an active cannabis microbusiness license since May 14, 2019.[3] However, according to respondent, appellant did not make any taxable distributions until the first quarter of 2021 (1Q21).
2. According to the audit workpapers, appellant used its cannabis microbusiness license to manufacture cannabis vape cartridges and distribute them to licensed cannabis retailers, distributors, and other microbusinesses.
3. Respondent determined by audit that appellant underreported average market price of total cannabis sales for the period 1Q21 through 1Q22 by a measure of $800,865. The quarterly measures were $840,516.23, $232,055.90, minus $299,566.05, minus $23,427.03, and $52,275.95, respectively, which equated to $120,130 in underreported cannabis excise tax for the five quarters at issue.
4. In addition, respondent's audit determined that appellant underreported cultivation tax by $757,714.
5. Pursuant to R&TC section 34013(f), respondent imposed a mandatory 50 percent penalty for appellant's failure to pay all cannabis taxes due.
6. On August 5, 2022, respondent issued the NOD.
7. Appellant filed a timely petition for redetermination.
8. Respondent conducted a reaudit, which reduced the underreported cultivation tax by $139,476 and reduced the failure-to-pay penalty to $369,183.93.
9. Respondent issued a decision reducing the liability pursuant to the reaudit, but otherwise denying the petition for redetermination. Appellant filed a request for reconsideration, which respondent denied in a supplemental decision issued on June 19, 2024. Appellant filed a second request for reconsideration, but respondent declined to consider it.
10. This timely appeal to OTA followed. Appellant appeals the penalty only.

[3] A microbusiness license authorizes the licensee to engage in limited cultivation of cannabis and to act as a distributor, manufacturer, and retailer of cannabis and cannabis products provided the licensee can demonstrate compliance with the laws governing such activities. (Bus. & Prof. Code, § 26001(an); R&TC, § 34010.)

DISCUSSION[4]

During the liability period, California imposed a 15 percent excise tax upon purchasers of cannabis or cannabis products sold in this state.[5] (R&TC, § 34011(a)(1).) The excise tax was measured by the average market price of any retail sale by a cannabis retailer. (*Ibid*.) The retailer was required to collect the excise tax from the purchaser and to give the purchaser an invoice, receipt, or other document (receipt) that informed the purchaser that the cannabis excise taxes were included in the total amount charged.[6] (R&TC, § 34011(a)(1),(2), (e).) The retailer would also remit the collected excise tax to the distributor of the cannabis, and the distributor was required to collect the excise tax from the retailer, and report and remit the excise tax to respondent. (R&TC, § 34011(b)(1).) The distributor was required to give the retailer a receipt that identified the licensee receiving the cannabis product, the distributor from whom the product originated, the amount of excise tax, and other information. (R&TC, § 34011(b)(2).)[7] Generally, the distributor or microbusiness that sells or transfers cannabis or cannabis products to a cannabis retailer is responsible for collecting the excise tax from the retailer based on the average market price of the cannabis or cannabis products supplied to the retailer (Cal. Code Regs., tit. 18, § 3700(j)(4)); and the cannabis distributor is required to report and remit the excise tax with the return for the quarterly period in which the distributor sells or transfers the cannabis or cannabis products to a cannabis retailer (Cal. Code Regs., tit. 18, § 3700(j)).[8]

In addition to the excise tax, California imposed on cultivators (growers) a cultivation tax on all harvested cannabis that entered the commercial market during the period

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[4] Some of the cannabis tax law was renumbered or otherwise amended, and those changes became effective after the liability period. In this Discussion section, OTA will cite to the law that was effective during the liability period.

[5] There were some exclusions or exemptions not relevant here.

[6] A licensee that sells cannabis or cannabis products designated as a trade sample pursuant to Business and Professions Code section 26153.1 was liable for the cannabis excise tax imposed by this section as if the person were a cannabis retailer. (R&TC, § 34011(g).)

[7] As used herein, the term "licensee" refers to a person licensed pursuant to Medicinal and Adult-Use Cannabis Regulation and Safety Act (Division 10 (section 26000 *et seq.*) of the Business and Professions Code.). There are at least 23 license classifications under the Act, including those for cultivation, processing, manufacturing, testing, distribution, microbusiness, and retail sales.

[8] A person that holds both a cannabis retailer license and a distributor license, or a license for a microbusiness that is authorized to act as a distributor, is subject to the same cannabis excise tax collection and reporting requirements as a person that holds only a distributor license. (Cal. Code Regs., tit. 18, § 3700(j)(1).)

January 1, 2018, through June 30, 2022.[9] (R&TC, § 34012.) Distributors were required to collect the cultivation tax from the grower when the grower was required to send, and did send, the harvested cannabis to a distributor. (R&TC, § 34012(h)(1).) When the grower sold or transferred unprocessed cannabis directly to a manufacturer, the manufacturer collected the cultivation tax from the grower and remitted the tax on cannabis products sold or transferred to a distributor for quality assurance, inspection, and testing, as described in Business and Professions Code section 26110. (R&TC, § 34012(h)(2)(A).) A distributor who conducts the required quality assurance review before the cannabis or cannabis products can be sold or transferred to a cannabis retailer pursuant to section 5307, of chapter 2, division 42 of title 16 of the Code of Regulations, is responsible for the remittance of the cultivation tax based on the weight and category of the cannabis that enters the commercial market. (Cal. Code Regs., tit. 18, § 3700(e).)

A licensee who fails to pay the cannabis excise or cultivation tax must also pay a mandatory penalty equal to one-half of the unpaid taxes and is subject to license revocation. (R&TC, § 34013(f); Cal. Code Regs., tit. 18, § 3700(k)(1).) Licensees are entitled to relief from the penalty if they are able to demonstrate that the failure to pay the cannabis excise and cultivation taxes in full was due to reasonable cause and circumstances beyond the licensee's control and occurred notwithstanding the exercise of ordinary care and the absence of willful neglect. (Cal. Code Regs., tit. 18, § 3700(k)(2).) The taxpayer has the burden of proving facts that support the request for relief. (Cal. Code Regs., tit. 18, § 30219(a); *Appeal of Porreca*, 2018-OTA-095P.) Any such request for relief must be supported by a statement under penalty of perjury setting forth the facts upon which the claim for relief is based. (Cal. Code Regs., tit. 18, § 3700(k)(2).) The sole question under review in this appeal is whether appellant should be relieved of the failure-to-pay penalty.

Appellant asserts that all errors were due to essentially innocent misunderstandings and that there was no intent to evade or avoid taxes. Appellant also contends that it (and presumably others who underpay cannabis taxes) should not be subject to a penalty under R&TC section 34013(f), which, it contends, was written for enforcement against unlicensed distributors, who unfairly compete with licensed distributors, and that applying the 50 percent penalty to appellant violates the spirit of the law and is unjust. It contends that, instead, OTA should apply R&TC section 6597.

[9] There is an exemption from the cultivation tax available for trade samples. (R&TC, § 34012.2.)

Appellant states that one of the errors that resulted in an underpayment was caused by an incorrect distribution report generated by its point-of-sale (POS) system for January 2021, the first month in which there was any distribution of cannabis of cannabis products. According to appellant, there was an empty line in the middle of the report, and the tax calculated by the POS system did not include the amount that should have been on the empty line. According to appellant, this undiscovered error caused appellant to report only about $60,000 of about $180,000 that was actually due for the month.[10] Appellant contends that the fact that respondent's auditor took many months to discover the error supports appellant's request for relief.

Appellant argues that underreported cultivation taxes of $34,000 were due to appellant's belief that the cultivation tax on at least one cannabis product – appellant describes the product as "oil" – was not due until the product was in final form and ready for distribution in the commercial market. Appellant contends that the cultivation tax law is misunderstood by many, and that it ultimately paid these taxes in later periods. Finally, appellant contends that the remaining cultivation tax underpayments were the result of appellant erroneously paying cultivation taxes to its vendors, who ultimately paid the taxes to respondent.

The controlling statute here is R&TC section 34013(f). It establishes a mandatory 50 percent penalty on cannabis tax underpayments, regardless of the taxpayer's intent. Appellant has cited no authority for its argument that the 50 percent penalty applies only to unlicensed persons, and OTA is not aware of any such authority. R&TC section 6597 imposes a sales or use tax penalty that applies when someone knowingly collects sales tax reimbursement or use tax and fails to remit the collected amount to respondent.[11] It does not apply to the cannabis excise or cultivation taxes.

There is no dispute regarding appellant's underpayment of both cannabis taxes. The issue is whether the evidence established grounds for relief.

Appellant's argument about the empty line in the January 2021 report is unpersuasive. OTA has insufficient evidence that appellant's request for relief accurately describes what occurred. At best, the record contains a brief that includes factual assertions that appellant certifies as true.[12] To OTA's knowledge, the record does not contain a copy of the report with

[10] The amounts appellant appears to indicate that this is the excise tax underpayment.

[11] The penalty applies only when the amounts collected but not remitted exceed specified thresholds. (R&TC, § 6597(a)(2)(A).)

[12] Unsupported assertions are insufficient to meet a taxpayer's burden of proof. (*Appeal of Talavera*, 2020-OTA-022P.)

the missing line or an explanation of why appellant could not discover the missing information before relying on the report to prepare its return. If the error was due to a missing line, that is simply an error by appellant, possibly due to a software problem but still something within appellant's control, and, just as likely as not, the result of appellant's failure to exercise ordinary care. OTA also notes that, according to the audit workpapers, respondent was not able to determine what caused the underreporting, at least in part due to the fact that appellant did not provide documents showing how reported amounts were calculated; but respondent noted that appellant's records appeared to show sales in excess of reported amounts. This is inconsistent with appellant's assertion that respondent discovered the empty line as the cause of the error, but it took respondent about a year to do so.

OTA also finds unpersuasive appellant's argument that the penalty for underreported cultivation tax should be relieved because the underreporting, by far the largest part of the deficiency, was due to appellant's misunderstanding when, and possibly by whom, the tax was to be remitted. The audit workpapers indicate that appellant did not have clear procedures on how the cultivation tax was calculated for the periods 4Q20 through 4Q21, the periods for which underpayments were determined, but that could just as likely have been due to circumstances totally within appellant's control. Even if there was evidence that appellant did not understand what was required, a misunderstanding of the law does not constitute reasonable cause for failing to comply. (*Appeal of Porreca*, *supra*.) If a taxpayer does not understand what the law requires, the taxpayer can seek assistance from the myriad resources available, including respondent's educational materials and other forms of taxpayer outreach and independent tax professionals, including some who specialize in cannabis tax law. For all the reasons stated above, OTA finds that appellant has not shown that it is entitled to relief from the failure-to-pay penalty.

HOLDING

Appellant is not entitled to relief from the failure-to-pay penalty.

DISPOSITION

Respondent's action denying, in part, appellant's petition for redetermination is sustained.

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Michael F. Geary
Administrative Law Judge

We concur:

DocuSigned by:
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Keith T. Long
Administrative Law Judge

Signed by:
47F45ABE89E34D0...
Suzanne B. Brown
Administrative Law Judge

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