

**CALIFORNIA STATE BOARD OF EQUALIZATION**  
**APPEALS DIVISION BOARD HEARING SUMMARY**

In the Matter of the Petition for Redetermination )  
Under the Sales and Use Tax Law of: )  
DURMAN, INC., ) Account Number SR SO 101-163449<sup>1</sup>  
Case ID 605242  
Petitioner ) Van Nuys, Los Angeles County

Type of Business: Medical marijuana dispensary

Audit period: 11/15/08 – 06/30/11

<u>Item</u>	<u>Disputed Amount</u>	<u>Tax</u>	<u>Penalty</u>
Unreported taxable sales	\$1,280,851		
Negligence penalty	\$ 12,174		
As determined		\$160,974.86	\$16,097.54
Post-D&R adjustment		- 39,235.30	- 3,923.55
Proposed redetermination, protested		<u>\$121,739.56</u>	<u>\$12,173.99</u>
Proposed tax redetermination		\$121,739.56	
Interest through 04/30/16		45,459.95	
Negligence penalty		<u>12,173.99</u>	
Total tax, interest, and penalty		\$179,373.50	
Payments		- 747.00	
Balance Due		<u>\$178,626.50</u>	
Monthly interest beginning 05/01/16		<u>\$ 604.96</u>	

This matter was scheduled for Board hearing in June 2015, but it was postponed for settlement consideration. It was then rescheduled for hearing in February 2016, but petitioner did not respond to the Notice of Hearing, and the matter was scheduled for decision on the nonappearance calendar in March 2016. Subsequently, petitioner filed a late response to the hearing notice and the matter was rescheduled for hearing.

<sup>1</sup> The account number was changed from SR AC 101-163449 to SR SO 101-163449 in February 2014 when the account was moved from the Van Nuys District office to the Santa Clarita District office.

**UNRESOLVED ISSUES**

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2 **Issue 1:** Whether any additional adjustments to the amount of unreported taxable sales are  
3 warranted. We find that no additional adjustments are warranted.

4 Petitioner operated a dispensary primarily selling medical marijuana, but also selling pipes,  
5 bongs, lighters, and other smoking accessories, from November 15, 2008, until its seller's permit was  
6 revoked, effective September 30, 2011. During a visit by staff of the Board's Statewide Compliance  
7 and Outreach Program (SCOP) to petitioner's business location on October 20, 2009, petitioner stated  
8 that it served 15 customers per day, on average, and that each customer spent an average of at least  
9 \$50. Based on petitioner's statements, the SCOP staff estimated quarterly sales of \$68,250 (\$50 per  
10 customer x 15 customers per day x 7 days x 13 weeks), which substantially exceeded petitioner's  
11 reported sales of \$6,191 for the second quarter of 2009. Given the discrepancy between estimated and  
12 reported sales amounts, the SCOP staff referred the case for an audit.

13 For audit, petitioner provided customer sign-in sheets for the period February 14, 2009, through  
14 June 30, 2009, a copy of a commercial lease agreement for a three-year period from November 2010  
15 through October 2013, and a Tenant Ledger. In the absence of any sales records, the Sales and Use  
16 Tax Department (Department) decided to establish audited taxable sales based on observation tests.  
17 From an outside location, the Department observed people entering and leaving petitioner's business  
18 location for one hour on each of four days in March 2011, and noted that each person entering the store  
19 left after approximately 15 minutes with a white paper bag. The Department concluded that petitioner  
20 sold merchandise to each person entering the store during the observation, and computed an average of  
21 five sales per hour. Based on petitioner's accountant's estimate that each sale averaged \$35, the  
22 Department computed audited taxable sales of \$175 per hour (5 sales x \$35). The Department  
23 multiplied 73 hours of operation for one week by 52 weeks to compute 3,796 annual operating hours,  
24 and multiplied that amount by \$175 to compute audited annual taxable sales of \$664,300. The  
25 Department then multiplied audited quarterly taxable sales of \$166,075 ( $\$664,300 \div 4$ ) by 10 quarters  
26 to establish audited taxable sales of \$1,660,750 for the period January 1, 2009, through June 30, 2011,  
27 and added audited taxable sales of \$83,038 ( $\$166,075 \div 2$ ) for the period November 15, 2008, through  
28 December 31, 2008, to establish audited taxable sales of \$1,743,788 for the audit period. However, as

1 stated in the D&R, we found that the Notice of Determination was not issued timely for the period  
2 November 15, 2008, through December 31, 2008. We also found that petitioner's contention that it  
3 closed its business in June 2010 in compliance with a letter received from the City of Los Angeles, and  
4 reopened in January 2011 following required construction work, was corroborated. Accordingly, we  
5 recommended that audited taxable sales be reduced by \$83,038 for the period November 15, 2008,  
6 through December 31, 2008, and by \$332,150 (\$166,075 x 2) for the third and fourth quarters of 2010,  
7 which resulted in audited taxable sales of \$1,328,600 for the audit period, and unreported taxable sales  
8 of \$1,280,851 in the post-D&R reaudit.

9       Following the issuance of the D&R, petitioner filed a request for reconsideration, in which it  
10 contends that its taxable sales were less than \$175 per hour, and that the audit did not account for  
11 discounts and gifts given to customers. Petitioner asserts that the Department erroneously assumed  
12 that each person leaving petitioner's business made a purchase of taxable merchandise, when actually,  
13 some of the bags that patients left with did not contain marijuana, but instead contained free gifts, such  
14 as pipes, grinders, zig-zags, pre-rolled joints, or lighters, which it provided to patients who were  
15 unhappy with marijuana previously purchased. Petitioner also asserts that some patients could only  
16 afford to purchase less than one gram, and thus, the audited average sale amount of \$35 is too high.  
17 According to petitioner, its selling prices for marijuana ranged from \$5.00 to \$15.00 per gram, and its  
18 daily sales ranged from \$350 to \$400. Petitioner argues that if it had made sales averaging \$175 per  
19 hour, it would have been able to meet its financial obligations and stay in business. In support,  
20 petitioner provided credit reports showing petitioner's president's unpaid debt.

21       Given that petitioner did not provide any records of its sales, we find that it was reasonable to  
22 establish audited taxable sales based on the results of observation tests. In the absence of any  
23 documentary evidence indicating that petitioner provided free gifts in white paper bags to patients, or  
24 other evidence indicating that the Department made incorrect assumptions regarding the number of  
25 sales made during the observation tests, we find that it is reasonable to rely on the Department's  
26 observation that petitioner made five sales per hour, on average. We note that, prior to the audit,  
27 petitioner informed SCOP staff that each customer spent an average of at least \$50, and, at the time of  
28 the audit, petitioner's accountant stated that each customer spent \$35. Based on these statements, we

1 find that relying on an average sale price of \$35 is reasonable. Also, we find that petitioner's  
2 contention that its average daily sales ranged from \$350 to \$400 is inconsistent with statements it made  
3 at the time of the SCOP investigation, when it stated that it made about 15 sales per day for about \$50  
4 each, which computes to daily sales of \$750. Regarding petitioner's president's credit reports, we find  
5 that the reports are of little value in determining the amount of sales made by petitioner. In the absence  
6 of any records of petitioner's sales, we find that audited taxable sales were established based on the  
7 best available evidence, and conclude that no adjustments are warranted.

8 **Issue 2:** Whether petitioner was negligent. We conclude that it was.

9 The Department imposed the negligence penalty because petitioner failed to provide any books  
10 and records, and because the amount of unreported tax is substantial relative to reported amounts.

11 Petitioner claims that it was not aware that its accountant reported incorrect sales amounts on  
12 the sales and use tax return filed for the first quarter 2011 (1Q11), and was not aware that its  
13 accountant had not filed the return for 2Q11. Petitioner asserts that it forwarded a check for \$980 to its  
14 accountant for purposes of filing the sales and use tax returns for 1Q11 and 2Q11. Additionally,  
15 petitioner asserts that its decision to withhold its books and records was influenced by advice it  
16 received from its accountant.

17 We find that the complete lack of books and records provided for examination is strong  
18 evidence of negligence in recordkeeping. Regarding the magnitude of the understatement, we note that  
19 a comparison of unreported taxable sales of \$1,280,851 with petitioner's reported taxable sales of  
20 \$47,749 shows a reporting error rate of 2,682 percent, which we find is egregious. Regarding  
21 petitioner's claim that its accountant did not file the correct returns for 1Q11 and 2Q11, suggesting that  
22 the accuracy of the reported amounts was beyond its control, we note that, in general, where an agent,  
23 employee, or partner of a taxpayer is guilty of negligence, with a resulting tax deficiency, the 10-  
24 percent penalty will apply. (Audit Manual § 0506.20.) This is true even though the agent, employee,  
25 or partner acted without the taxpayer's knowledge or consent, or acted contrary to the express  
26 instructions of the taxpayer. (Audit Manual § 0506.20.) Further, we note that, for 2Q09, petitioner  
27 reported sales of only \$6,191, even though it told SCOP staff that it served 15 customers per day, on  
28 average, and that each customer spent an average of at least \$50, which equates to quarterly sales of

1 \$68,250. Given that petitioner provided no records and estimated its sales to be more than 10 times the  
2 amount it reported, we find that petitioner's bookkeeping and reporting errors cannot be attributed to  
3 its bona fide and reasonable belief that its bookkeeping and reporting practices were sufficiently  
4 compliant with the requirements of the Sales and Use Tax Law. Under such circumstances, the  
5 imposition of a negligence penalty in a first-time audit is appropriate. (*Cf. Independent Iron Works,*  
6 *Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 321-324.)

7 Accordingly, although this was petitioner's first audit, we conclude that petitioner was  
8 negligent and the penalty is appropriate.

9 **OTHER MATTERS**

10 None.

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15 Summary prepared by Lisa Burke, Business Taxes Specialist III  
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