

**OFFICE OF TAX APPEALS
STATE OF CALIFORNIA**

In the Matter of the Appeal of:)	OTA Case No. 18010877
)	
RICHARD L. FOUST)	Date Issued: January 3, 2019
)	
)	
)	

OPINION

Representing the Parties:

For Appellant: Richard L. Foust, Taxpayer

For Franchise Tax Board (FTB): Eric R. Brown, Tax Counsel III

G. THOMPSON, Administrative Law Judge: Pursuant to California Revenue and Taxation Code (RTC) section 19045, Richard L. Foust (appellant) appeals actions by FTB on his protests against proposed assessments for the 2008 and 2009 tax years. For the 2008 tax year, FTB proposed \$9,650 in additional tax, a late-filing penalty of \$2,412.50 and an accuracy-related penalty of \$1,930, plus accrued interest. For the 2009 tax year, FTB proposed \$11,870 in additional tax and an accuracy-related penalty of \$2,374, plus accrued interest.¹

Appellant did not request an oral hearing and therefore the matter is being decided based on the written record.

ISSUE

Whether appellant has shown error in FTB’s proposed assessments for 2008 and 2009, which were based on federal adjustments.²

¹ On appeal, FTB agreed to reduce its proposed assessment for the 2009 tax year to \$10,951 in additional tax and an accuracy-related penalty of \$2,190.20.

² Appellant has not raised any arguments concerning the imposition of the accuracy-related penalties, the late-filing penalty imposed for 2008, or the interest imposed, and we see no error in FTB’s imposition of these penalties (as modified on appeal to reduce the 2009 accuracy-related penalty) and interest, or grounds for abating the penalties or interest.

FACTUAL FINDINGS

1. On April 15, 2010, appellant filed a late California Resident Income Tax Return for the 2008 tax year and a timely California Resident Income Tax Return for the 2009 tax year. Later in 2010, appellant submitted payment of the tax shown as due on his 2008 California tax return, plus a late-filing penalty, interest, and a collection cost fee.
2. Appellant's 2008 California tax return reported itemized deductions of \$30,710, and his 2009 California tax return reported itemized deductions of \$79,068.
3. Appellant also claimed legal expense deductions on Schedule A of his 2008 and 2009 tax returns. For 2008, he claimed a deduction of \$25,000. For 2009, he claimed a legal expense Schedule A deduction of \$75,500. This \$75,500 amount included \$25,000 of legal fees reflected in an invoice dated July 31, 2009. The IRS and FTB later disallowed these claimed deductions. However, as discussed below, on appeal, FTB has allowed a \$25,000 legal fee deduction on Schedule A for the 2009 tax year.
4. Both returns also claimed deductions for a Schedule C business that generated no sales or gross income during 2008 or 2009.
5. Appellant's 2008 Schedule C listed a business of "Project Consulting," and claimed \$201,849 in business expense deductions. As no income was reported for the business, the claimed business expense deductions of \$201,849 resulted in a loss in the same amount.
6. The \$201,849 of business expense deductions listed on appellant's 2008 Schedule C included the following claimed deductions: a meals and entertainment expense deduction of \$37,099; \$10,139 of travel expenses; \$5,614 of insurance expenses; and "other expenses" of \$44,154. The largest item in the "other expenses" category was a claim of \$35,912 in professional fees.
7. Appellant's 2009 Schedule C also listed a business of "Project Consulting" and claimed \$147,772 in business expense deductions for the business. As no income was reported for the business, the claimed business expense deductions of \$147,772 resulted in a loss in the same amount. Appellant reported an overpayment of \$14,117, and FTB refunded this amount to him.
8. The \$147,772 of business expense deductions claimed by appellant on his 2009 Schedule C included the following: a meals and entertainment expense deduction of

\$19,204, \$7,682 for travel expenses, \$7,022 for insurance expenses, \$10,398 of office expenses, and \$32,361 in “other expenses.” The largest item in the “other expenses” category was a claim of \$19,642 in professional fees.

9. On December 20, 2012, the Internal Revenue Service (IRS) notified FTB that it had examined appellant’s federal tax returns for 2008 and 2009 and made adjustments that increased the amount of tax due.
10. For the 2008 tax year, the IRS disallowed all of appellant’s claimed deductions for meals and entertainment, insurance, and travel. It also disallowed “other expenses” of \$35,912, which was the amount of professional fees claimed by appellant. The IRS allowed the remaining “other expenses” of \$8,242 (\$44,154 claimed, less the \$35,912 amount disallowed).³
11. For the 2009 tax year, the IRS disallowed all of the deductions appellant claimed for meals and entertainment, travel, insurance and office expenses. It also disallowed \$19,642 of “other expenses” claimed by appellant, which was the amount of professional fees claimed by appellant. The IRS allowed the remaining “other expenses” of \$12,719 (\$32,361 claimed, less the \$19,642 amount disallowed).
12. Appellant did not notify FTB of the IRS adjustments.
13. On October 25, 2013, appellant filed an Offer in Compromise (OIC) with the IRS for the 2008 tax year. The OIC was based on doubt as to liability.
14. On November 12, 2013, FTB issued a Notice of Proposed Assessment (NPA) for the 2008 tax year. In the NPA, FTB followed the adjustments made by the IRS, to the extent applicable under California law.
15. On February 4, 2014, FTB issued a NPA for the 2009 tax year. Like the NPA for the 2008 tax year, the NPA for 2009 followed the adjustments made by the IRS, to the extent applicable under California law.
16. Appellant protested the NPAs. In each protest, appellant’s representative argued that appellant’s tax preparer did not provide adequate representation during the IRS audit. The representative further argued that appellant had thought that all relevant documents had been produced when, in fact, the documents were not produced. The representative

³ The IRS also made various adjustments that are not at issue. Among other things, the IRS adjusted appellants’ claimed Schedule A deductions, but appellant did not contest these adjustments in his appeal.

stated that appellant believed that evidence was available to substantiate at least some of the disallowed deductions. However, appellant submitted no evidence during the protest process.

17. In appellant's protest for the 2008 year, and in a letter dated March 11, 2014, appellant's representative noted that appellant had filed an OIC with the IRS. In his March 11, 2014 letter, appellant's representative requested that FTB defer protest proceedings for the 2008 tax year until the IRS processed appellant's OIC.
18. On March 26, 2014, FTB notified appellant that it would defer the proposed assessment for 2008 pending determination of appellant's OIC.
19. On August 14, 2014, the IRS denied appellant's OIC.
20. Although the IRS denied appellant's OIC, it again examined appellant's account.
21. On October 10, 2014, the IRS notified FTB that it had further adjusted appellant's tax liabilities for the 2008 and 2009 tax years. As relevant here, for 2008, the IRS allowed a \$12,171 Schedule C meal and entertainment deduction (as compared to the \$37,099 deduction claimed by appellant). For 2009, the IRS allowed a \$6,717 meals and entertainment deduction (as compared the \$19,204 deduction claimed by appellant).
22. On October 13, 2014, FTB notified appellant that it had received federal information indicating that the IRS had completed its review of appellant's 2008 tax year. FTB requested that appellant provide a copy of the federal report detailing the IRS changes. FTB stated that if appellant did not reply it would adjust appellant's 2008 liability based on the available information. There is no indication that appellant responded.
23. On February 5, 2015, FTB issued Notices of Action (NOAs) for the 2008 and 2009 tax years.
24. In the NOA for 2008, FTB revised its proposed assessment to allow the \$12,171 amount allowed by the IRS as a Schedule C meals and entertainment deduction. After this revision, the amount of Schedule C meals and entertainment expenses disallowed by FTB was \$24,928 (i.e., the \$37,099 amount disallowed in the NPA, less the \$12,171 amount subsequently allowed). The NOA otherwise affirmed the proposed assessment reflected in the NPA.
25. In the NOA for 2009, FTB revised its proposed assessment to allow the \$6,717 Schedule C meals and entertainment deduction allowed by the IRS. After this revision,

the amount of Schedule C meals and entertainment expenses disallowed by FTB was \$12,487 (i.e., the \$19,204 amount disallowed in the NPA, less the \$6,717 amount subsequently allowed). The NOA otherwise affirmed the proposed assessment reflected in the NPA.

26. Appellant then filed this timely appeal. Through his representative at that time, he asserted that he did not have the chance to address the proposed assessments or provide supporting documents during the protest period.⁴ He stated that he “contends he has sufficient documentation to [substantiate] the disallowed [Schedule C] expense items” for the tax years at issue. He did not contest the disallowance of Schedule A deductions or the imposition of penalties or interest. He further stated that he would like to reach a settlement with FTB.
27. The Board of Equalization (BOE) acknowledged appellant’s appeal and advised him that, if he was interested in a settlement with FTB, he should contact FTB. The BOE provided appellant with contact information for individuals in FTB’s Settlement Bureau and a publication from FTB outlining FTB’s settlement procedures.⁵
28. The BOE deferred the appeal for three months to allow time for appellant to submit documents in support of his appeal letter.
29. Appellant did not submit any documents during the deferral period and the appeal was reactivated.
30. FTB then filed its opening brief. In its brief, FTB stated that it had contacted appellant’s representative to obtain any supporting documents, but had not received any. FTB requested that appellant provide any available supporting document as soon as possible.
31. BOE then invited appellant to file a reply brief. Rather than filing a reply brief, appellant submitted 448 pages of documents, including receipts, bank statements, invoices, schedules, and ticket stubs.
32. After reviewing the documents, FTB filed a reply brief. FTB determined to allow

⁴ Appellant is no longer represented by this or any other representative.

⁵ There is no indication that appellant contacted FTB’s Settlement Bureau.

\$25,000 of Schedule A legal expenses for 2009.⁶ As a result, FTB reduced its proposed assessment for 2009 to \$10,951 in additional tax and a \$2,190.20 accuracy-related penalty. FTB argued that no further adjustments were warranted.

33. The Office of Tax Appeals provided appellant with the opportunity to file a brief to respond to FTB's reply brief, but appellant did not do so.

DISCUSSION

When the IRS makes changes or corrections to an individual's tax return and the changes increase the amount of tax owed, the taxpayer must either concede the accuracy of the federal determination or prove that the federal adjustments are erroneous. (RTC, § 18622(a).) An FTB deficiency assessment that is based on a federal audit report is presumed to be correct. (*Appeal of Aaron and Eloise Magidow*, 82-SBE-274, Nov. 17, 1982.)⁷ Also, the taxing agency's determination that an item is not deductible is presumed correct, and the taxpayer has the burden of proving it to be wrong. (*Smith v. Commissioner* (9th Cir. 2002) 300 F.3d 1023, 1029.)

Internal Revenue Code (IRC) section 162(a) authorizes a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."⁸ (*Roberts v. Commissioner*, T.C. Memo. 2012-197.) A trade or business expense is ordinary for purposes of IRC section 162 if it is normal or customary within the particular trade, business, or industry, and is necessary if it is appropriate and helpful for the development of the business. (*Roberts v. Commissioner*, *supra*.) In contrast, personal, living, or family expenses are generally not deductible. (*Ibid*.)

Legal Fees Claimed as "Other Expenses" on Schedule C

The largest category of disallowed Schedule C deductions are legal fees claimed as "other expenses" on Schedule C. The IRS and FTB allowed all of appellant's claimed "other

⁶ As noted above, appellant has not contested the imposition of interest and penalties or the disallowance of claimed Schedule A deductions. The documents provided by appellant do not substantiate any Schedule A deductions beyond the amount allowed by FTB, and there appears to be no basis to abate interest or penalties.

⁷ Board of Equalization (BOE) opinions are generally available for viewing on the BOE's website: <<http://www.boe.ca.gov/legal/legalopcont.htm#boeopinion>>.

⁸ IRC sections 162, 262, 274, and 280F are generally incorporated into California law by RTC section 17201.

expenses” except for the professional fees of \$35,912 and \$19,642 appellant claimed for 2008 and 2009, respectively.

Appellant has not provided any documentation of legal fees paid during 2008. He has provided documents related to legal payments made in 2009, but these documents relate to the \$75,500 of legal expenses he claimed on his Schedule A for 2009, rather than the professional fees he claimed as “other expenses” on Schedule C. The \$75,500 of Schedule A legal expenses claimed appear to consist of \$50,000 in legal fees paid by Valli Construction Inc., \$25,000 paid by him and reflected in a July 31, 2009 invoice, and \$500 paid to Gallagher, Reddy, & Jones. We briefly address each of these items below.

With regard to the \$50,000 in legal fees paid by Valli Construction, Inc., appellant is not entitled to any deduction because he did not pay these amounts.⁹

Appellant provided another invoice, dated July 31, 2009, showing \$25,000 of legal fees. Based on this invoice and other supporting documentation, FTB has agreed to allow this \$25,000 of the \$75,500 of Schedule A legal expenses claimed by appellant for 2009. Therefore, the deduction of this amount is not at issue.

Appellant’s claimed legal expense for 2009 also included \$500 paid to Gallagher, Reddy, & Jones. However, the record does not show the purpose of the payment, or whether it was related to appellant’s business, the production of income, or his personal affairs. Accordingly, appellant has not shown that he is entitled to a deduction of this amount.

In conclusion, appellant has not shown any basis for deducting any additional professional fees beyond the \$25,000 of professional fees already allowed by FTB.

Meals and Entertainment Expenses

Although appellant reported that his business earned no revenue during 2008 and 2009, he claimed meals and entertainment deductions of \$37,099 for 2008 and \$19,204 for 2009. Generally, only one half of meals and entertainment expenses may be deducted. (IRC, § 274(n).) Therefore, appellant’s claimed meals and entertainment deductions for 2008 and 2009 equate to claimed meal and entertainment expenses of \$74,198 for 2008 and \$38,408 for 2009. We note

⁹ Appellant provides calculations suggesting that a bonus he might otherwise have received was reduced by the amount of this \$50,000 in legal fees paid. Even if this is the case, we see no basis to allow appellant a deduction for an expense he did not incur.

that this seems to be a rather large amount of meals and entertainment expenses for a business that had no sales or income during the years at issue.

Like the IRS, FTB allowed a meals and entertainment deduction of \$12,171 for 2008 and \$6,717 for 2009. As only one-half of appellant's qualified meals and entertainment expenses may be deducted, this equates to allowed meals and entertainment expenses of \$24,342 for 2008 and \$13,434 for 2009, as compared to the \$74,198 of such expenses claimed for 2008 and \$38,408 of such expenses claimed for 2009. On appeal, appellant bears the burden of showing that he is entitled to a greater amount of meals and entertainment expenses than the amount already allowed by the IRS and FTB.

IRC section 274(d) imposes strict substantiation requirements for meals and entertainment expenses. IRC section 274(d) requires a taxpayer to substantiate expenses by adequate records or other corroborating evidence of (1) the amount of each expense, (2) the time and place of the expense, and (3) the business purpose of the expense. The Tax Court explains that: "Generally, expenses subject to the strict substantiation requirements of [IRC] section 274(d) must be disallowed in full unless the taxpayer satisfies every element of those requirements." (*Fleming v. Commissioner*, T.C. Memo. 2010-60.)

"A taxpayer must show a bona fide business purpose for the expenditure, and there must also be a proximate relationship between the expenditure and his or her business." (*Linzy v. Commissioner*, T.C. Memo. 2013-219, *2 [citation omitted].) In addition, "[a] taxpayer's general statement that his or her expenses were incurred in pursuit of a trade or business is not sufficient to establish that the expenses had a reasonably direct relationship to any such trade or business." (*Ibid.* [citing *Ferrer v. Commissioner* (1968) 50 T.C. 177, 185, *affd. per curiam* (2d Cir. 1969) 409 F.2d 1359].) "Receipts often fail as proof because they don't show any particular business purpose." (*H & M, Inc. v. Commissioner*, T.C. Memo. 2012-290, fn. 17.)

For meal expenses, appellant provided receipts and a chart showing the date, amount, name of the restaurant, the client's name, the client's company and a general statement with a claimed business purpose. Claimed business purposes include the following: "CAS Suites," "Phone Systems"; "Travel – Hilton Inn Owners Group"; "Investments"; "Opps"; "Operations meeting"; and "Marketing Meeting." Appellant did not provide any written argument, evidence or explanation to support the claimed business purposes.

In its reply brief, FTB pointed out that appellant had not provided evidence to support the claimed business purposes, such as copies of contracts or other documents to demonstrate that appellant's business was involved. FTB also noted that there was no evidence to show that a bona fide business discussion actually took place in connection with the meals. FTB stated that it appeared that the IRS had allowed one-half of the claimed meal expenses for which appellant provided receipts. Appellant was provided with an opportunity to reply to FTB's brief, but he did not do so.

We do not see any error in FTB's determination that appellant is not entitled to additional deductions for meals beyond those already allowed by it and the IRS. Appellant also claimed as business expenses season tickets for sports teams, concerts, and sporting events. However, like the claimed meal expenses, appellant has not shown that the expenses were primarily incurred for a business purpose, rather than for personal entertainment.

In summary, appellant has not shown that he is entitled to additional meal and entertainment deductions beyond those allowed by the IRS and FTB.

Travel Expenses

Appellant claimed Schedule C travel expenses of \$10,139 and \$7,682 for 2008 and 2009, respectively. In accordance with the IRS's determination, FTB disallowed all of the claimed expenses.

Treasury Regulation section 1.274-5T(b)(2) requires that appellant substantiate the amount of each expense, the dates and destinations of travel, and the business reason for each claimed expense.

For 2008, appellant submitted documentation for less than \$5,000 of his claimed expenses of \$10,139. The largest claimed expense for which any documentation was provided is a \$1,418.04 expense for a Royal Caribbean Cruise. Appellant states that the cruise was for a "Synnex Client Event," but there is no documentation regarding the nature of this event or how it related to appellant's business. Similarly, for other claimed expenses, appellant references client projects or events such as "Sierra Hotel Group Site Meeting," "AMA Valli Motorsports Factory Sponsor Event," and "Auto Nation Client David Litty." However, there is no documentation of these events or projects, or how they related to appellant's business.

For 2009, appellant provides a chart showing \$6,808.56 of claimed expense items out of the \$7,682 of expenses claimed on his return. However, appellant provides documentation for

less than \$2,000 of such expenses. Like appellant's claimed travel expenses for 2008, appellant provides general statements of projects or events such as "AMA Valli Motorsports Factory Yamaha," "Campisi Office Project," "Generations Healthcare Job," and "Sierra hotel Group Site Meeting." However, there is no documentation of these events or projects, or how they related to appellant's business.

The documentation provided by appellant fails to establish error in the determination of FTB that appellant is not entitled to the claimed travel expenses. In many cases, there are no documents showing that appellant incurred the claimed expenses. Most important, even where there are documents showing the claimed expenses were incurred, there is no documentation to support appellant's claimed business purposes for the trips. Accordingly, there is no basis for us to find that appellant is entitled to the claimed deductions for travel expenses.

Insurance Expenses

Appellant claimed a deduction on Schedule C for insurance expenses of \$5,614 and \$7,022 for 2008 and 2009, respectively.¹⁰ The IRS, and FTB, disallowed all of the claimed expenses.

On appeal, appellant provides banking records that show insurance payments made to Farmers Insurance. However, he provides no documents to show that the insurance expenses were related to his business. As a result, he has not demonstrated any error in the determinations of the IRS and FTB that he is not entitled to the claimed business deductions for insurance expenses.

Office Expenses

Appellant claimed \$10,398 as a business deduction for office expenses for the 2009 tax year. The IRS and FTB disallowed the claimed deduction, and appellant has provided no evidence to support it. Accordingly, he has not shown that he is entitled to the claimed deduction for office expenses.

¹⁰ On appeal, appellant provides charts asserting that he incurred \$6,581.19 of insurance expenses for 2008, and \$9,666.89 of insurance expenses for 2009.

HOLDING

Appellant has not shown error in FTB's proposed assessments for 2008 and 2009, which were based on federal adjustments.

DISPOSITION

FTB's actions are sustained with the modification that, as conceded by FTB on appeal, the proposed assessment for the 2009 tax year is reduced to \$10,951 in additional tax and an accuracy-related penalty of \$2,190.20, plus accrued interest.

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Grant S. Thompson
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Grant S. Thompson
Administrative Law Judge

We concur:

DocuSigned by:
Kenneth Gast
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Kenneth Gast
Administrative Law Judge

DocuSigned by:
Jeffrey L. Margolis
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Jeffrey Margolis
Administrative Law Judge