

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:) OTA Case No. 18011729
MATTHEW C. DRAKE AND)
SUSAN K. DRAKE) Date Issued: April 3, 2019
_____)
_____)

OPINION

Representing the Parties:

For Appellants: Charles Van Kirk, Enrolled Agent
For Respondent: Bradley J. Coutinho, Tax Counsel

KWEE, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19324, Matthew C. and Susan K. Drake (appellants) appeal an action by respondent Franchise Tax Board (FTB) in denying appellants’ claim for refund in the amount of \$959 for the 2012 tax year. This matter is being decided based on the written record because appellants waived their right to an oral hearing.

ISSUES

1. Whether appellants timely filed a refund claim with respect to the investment interest expense deduction.
2. Whether appellants established error in FTB’s proposed assessment, which is based on a final federal determination.

FACTUAL FINDINGS

1. On or around April 13, 2013, appellants timely filed a joint California Resident Income Tax Return (Form 540), reporting federal adjusted gross income (AGI) of \$148,626, and no California adjustments to income. Appellants’ reported federal AGI included total income from four activities described on Schedule E, line 28, under “Income or Loss from Partnerships and S Corporations.” As relevant to this appeal, this amount included

\$6,517 in nonpassive income from Leonaco LLC.¹ Leonaco LLC is taxed as a partnership. Appellant-husband held a 50 percent ownership interest in Leonaco LLC during 2012.

2. Subsequently, on or around November 17, 2014, the Internal Revenue Service (IRS) made a federal correction to appellants' federal AGI, and increased it by \$15,015, for a corrected federal AGI of \$163,641. The federal correction was based on appellants' failure to report interest and dividend income of \$15,015. Based on the increased AGI, the IRS decreased appellants' itemized deductions by \$300.² No federal changes were made with respect to the nonpassive income from Leonaco LLC.
3. On October 21, 2015, FTB issued a Notice of Proposed Assessment (NPA) proposing to make the same adjustments to income at the state level, that the IRS had made at the federal level. Appellants did not dispute the NPA, the liability went final, and appellants paid the liability on January 19, 2016.
4. On or around April 18, 2016, appellants filed an amended California Income Tax Return (Form 540X), reporting amended federal AGI of \$138,517, which represents a reduction of \$10,109 from the originally reported AGI, and no California adjustments. Appellants' amended California return failed to report the \$15,015 in interest and dividend income as previously assessed by the IRS. Appellants' stated reason for filing the amended state return was that they had received an "amended" Schedule K-1, dated June 20, 2012, from Leonaco LLC. As relevant, the amended Schedule K-1 reported a net nonpassive loss in the amount of \$3,591, which appellants reported on Schedule E, line 23, activity C. This is a change of \$10,108 less than the originally reported nonpassive income of \$6,517, for this same activity.³ Due to the claimed \$10,109⁴ reduction in AGI, appellants claimed an

¹ This amount was reported on reported Schedule E on line 28, activity C. Appellants separately reported a \$1,607 loss from Leonaco LLC on Schedule E, line 28, activity B.

² The increase in AGI increased the AGI limitation by two percent of \$15,015; here, \$300. (R&TC, § 17076; Int.Rev. Code, § 67(a).)

³ The amended Schedule E, line 28, amounts for activities A, B and D are the same as the original return.

⁴ The record contains no explanation for the \$1 discrepancy between this amount and the supporting schedule amount of \$10,108.

5. increase in their miscellaneous itemized deduction by \$203.⁵ Based on these two changes, appellants reported a claimed overpayment of \$959 in tax, for which they requested a refund. FTB accepted the amended state tax return as a claim for refund.
6. Three days later, appellants filed an amended federal tax return with the IRS reflecting the Schedule K-1 change described above. It was processed as a claim for refund. The IRS issued a notice disallowing the federal refund claim on or around December 25, 2017.
7. FTB responded to the state refund claim by letter dated May 22, 2017, stating that the amended figures did not conform to the federal corrections made by the IRS, and requested appellants to provide evidence that the IRS had cancelled or revised the federal determination. Appellants failed to respond to this request.
8. FTB issued a Notice of Action (NOA) denying the state refund claim on July 10, 2017.
9. Appellants timely appealed the NOA on September 7, 2017. Appellants attached a different California amended return to their appeal letter. Appellant offered no explanation for the differences between this amended return and the amended return appellants filed with FTB on April 18, 2016. This amended return reported federal AGI of \$157,584 (which was less than the corrected federal AGI of \$163,641 as determined by the IRS). Another difference was that appellants claimed an additional itemized deduction amount of \$17,036, for investment interest expense.⁶
10. FTB responded by letter dated April 16, 2018, stating that the amended return dated January 19, 2016, had not been provided to FTB until it was attached to appellants' September 8, 2017 appeal letter. FTB further contends that, since this issue was never previously raised with FTB, it is not at issue in this appeal.

DISCUSSION

1. The Claimed Investment Interest Expense Deduction of \$17,306

As a preliminary matter, the law imposes time limits and other requirements on making and filing a claim for refund. (See R&TC, §§ 19306-19322.1.) As relevant here, one

⁵This reflects the reduction in the AGI limitation by two percent of \$10,109 (here, \$202.18, which appellants rounded up to \$203). (R&TC, § 17076; Int.Rev. Code, § 67(a).)

⁶By letter dated September 14, 2018, we requested additional briefing from appellants regarding its claimed investment interest expense. Appellants did not respond to our request.

requirement is that the claim must state the specific grounds upon which it is founded. (R&TC, § 19322.) Generally, it is not necessary for every specific ground to be pleaded within the four corners of the refund claim, provided the taxing authority is placed on notice of a particular ground. (*J.H. McKnight Ranch, Inc. v. Franchise Tax Bd.* (2003) 110 Cal.App.4th 978, 986-987.) Regarding time limits to file a refund claim, the law provides that no credit or refund may be allowed unless a claim for refund is filed within the later of: (1) four years from the date the return was filed, if the return was timely filed pursuant to an extension of time to file; (2) four years from the due date for filing a return for the year at issue (determined without regard to any extension of time to file), or (3) one year from the date of overpayment. (R&TC, § 19306.)

The deadline to timely file a claim for refund expired on April 15, 2017, because appellants timely filed their 2012 tax return. (See R&TC, § 19306(a).) Thus, appellants' claim for refund (i.e., the first amended return) was timely filed on April 15, 2016. In that claim, appellants failed to raise any issue or contention with respect to the possibility of a \$17,036 investment interest expense deduction.

The California investment interest expense issue was raised in appellants' amended return dated January 19, 2016, but there is no evidence to support appellants' claim that this amended return was timely filed with the FTB. FTB claims not to have received it before it was submitted with appellants' appeal letter of September 7, 2017, and FTB's records support this contention. During the briefing process, we requested that appellants provide any evidence which appellants believe timely placed FTB on notice that appellants were requesting a refund on the basis of a deduction for investment interest expense. To date, appellants have failed to provide any evidence showing that they timely raised the investment interest expense issue with FTB. Thus, based on the evidentiary record before us, we find that appellants first placed FTB on notice of this issue in their September 7, 2017, appeal of the NOA. This date is past the statute of limitations set forth in R&TC section 19306(a). Moreover, because the IRS did not make a change to appellants' federal investment interest expense deduction of \$0.00,⁷ appellants are not entitled to the extended limitations period set forth in R&TC section 19311 for federal

⁷ On Form 3526, line 9, of appellants' January 19, 2016 amended California return, appellants reported that they claimed a federal deduction of \$0.00 for investment interest expense.

income changes. Therefore, we find that appellants failed to timely file a claim for refund with respect to the claimed investment interest expense deduction.⁸

2. The Federal Action

Gross income means all income from whatever source derived, unless specifically excluded. (R&TC, § 17071; Int.Rev. Code, § 61(a).) The taxpayer bears the burden of establishing entitlement to any deductions claimed. (*Appeal of Gilbert W. Janke*, 80-SBE-059, May 21, 1980; *Appeal of J. Walshe and M. Walshe*, 75-SBE-073, Oct. 20, 1975.)⁹ If the IRS makes a change or correction to any item of gross income or deduction (federal change), the taxpayer must report the federal change to the FTB within six months after the date of each final federal determination related thereto, and shall concede the accuracy of the final federal determination or state wherein it is erroneous. (R&TC, § 18622(a).) An NPA issued by FTB based on such a final federal determination is presumed correct, and the taxpayer bears the burden of proving error. (*Appeal of S. Brockett and H. Brockett*, 86-SBE-109, June 18, 1986.)

Here, FTB issued the NPA based on a final federal determination that appellants failed to report interest and dividend income of \$15,015. The NPA makes the same changes at the state level that were made at the federal level. Appellants claim that their additional income should be offset by nonpassive losses, based on an amended California Schedule K-1 (Member's share of income, deductions, credits, etc.) that appellants allegedly received from Leonaco LLC, an entity in which appellants held a 50 percent share of the profits, losses, and capital. Nevertheless, FTB has no record of receiving an amended return reporting these changes from Leonaco LLC. Furthermore, the final federal determination upon which FTB's proposed assessment is based did not allow these losses.

Appellants' September 7, 2017, appeal letter contends that a federal "amended tax return was filed at the same time as the [state] amended" return to report the amended Schedule K-1 information and the investment interest expense information, and this amended return is still being processed by the IRS. According to the IRS information submitted by FTB, the IRS issued a notice denying appellants' claim for refund on or around December 25, 2017. Therefore, we

⁸ In reaching this conclusion, we offer no opinion on the substantive merits of the claim.

⁹ Precedential decisions of the State Board of Equalization, designated by "SBE" in the citation, are available on that board's website at < www.boe.ca.gov/legal/legalopcont.htm>.


find that the NPA proposes to assess tax based on a final federal determination, and appellants failed to establish error in that determination.

HOLDINGS


1. Appellants failed to timely file a refund claim with respect to the investment interest expense deduction.
2. Appellants failed to establish error in FTB's proposed assessment.


DISPOSITION

FTB's action is sustained.

DocuSigned by:

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Andrew J. Kwee
Administrative Law Judge

We concur:

DocuSigned by:

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John O. Johnson
Administrative Law Judge

DocuSigned by:

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Tommy Leung
Administrative Law Judge