OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18011780
WILLIAM NELSON	)
	) Date Issued: April 23, 2019
	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Tax Appeals Assistance Program (TAAP)[1]
For Respondent:	Meghan McEvilly, Tax Counsel III
For the Office of Tax Appeals:	Andrew Jacobson, Tax Counsel III

T. STANLEY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, William Nelson (appellant) appeals an action by the Franchise Tax Board (FTB) proposing an assessment of $1,633 in additional tax and an accuracy-related penalty of $326.60, plus interest, for the 2010 taxable year.[2]

Appellant has waived his right to an oral hearing; therefore, we decide this matter based on the written record.

ISSUES

1. Has appellant demonstrated error in FTB's proposed assessment, which is based on federal adjustments?
2. Has appellant established that the accuracy-related penalty should be abated?

[1] Appellant filed his own appeal letter. Tyler Jaramillo of TAAP filed appellant's opening brief, Andrew Forgy of TAAP filed appellant's reply brief, and Noel Garcia of TAAP filed appellant's supplemental brief.

[2] Following concessions by both appellant and FTB on appeal, the claimed deductions that remain at issue in this appeal are disallowed Schedule C other expenses of $9,387.48 and travel expenses of $4,750. FTB agrees to allow other expenses of $2,853.12, including: (1) claimed bank charges of $813.12; (2) communications expenses of $1,594; and (3) business expenses of $446. In his reply brief, appellant concedes he cannot support the remaining claimed other expenses of $4,835.52 ($4,339.07 according to FTB) with receipts.

FACTUAL FINDINGS

1. Appellant is a Canadian citizen who operated a company that has places of business in both San Diego, California, and Toronto, Canada. Appellant spends 80 percent of the year in San Diego. Appellant obtained an H-1B Visa in order to work as a non-citizen in the United States. Appellant travelled repeatedly between California and Canada during 2010.
2. On October 15, 2011, appellant filed a timely 2010 California Resident Income Tax Return (Form 540) which reported California adjusted gross income (AGI) of $51,424, taxable income of $47,754, and tax of $2,275. After deducting a personal exemption credit of $198, his total tax liability was $2,077. Appellant remitted a payment of $500 with the return. FTB processed the return and accepted it as filed.[3]
3. Appellant filed a 2010 federal income tax return (Form 1040) on October 19, 2011. On his 2010 federal Schedule C, Profit or Loss From Business, appellant listed his principal business or profession as a management consultant with a business address in La Jolla, California. Expenses claimed on Schedule C that are at issue here consist of the following: (1) car and truck expenses of $5,143; (2) travel, meals, and entertainment of $4,750, and (3) other expenses of $14,223.
4. Appellant's other expenses of $14,223 included: (1) bank charges of $4,244; (2) dues and professional subscriptions of $348; (3) communications expenses of $3,188; (4) computer expenses of $1,149; (5) consulting fees of $2,800; (6) business expenses of $1,495; (7) parking expenses of $25; and (8) client gifts of $974.
5. FTB subsequently received information from the Internal Revenue Service (IRS) reflecting federal adjustments resulting in an increase of $17,191 to appellant's 2010 taxable income. The IRS disallowed Schedule C travel expenses of $4,750 and Schedule C other expenses of $13,726.55, and allowed additional Schedule C car and truck expenses of $1,285.13. The IRS assessed additional tax of $4,300 and imposed an accuracy-related penalty.
6. Based on the federal adjustments, FTB issued appellant a Notice of Proposed Assessment

[3] Because appellant failed to pay the tax liability reported on the return by the payment due date of April 15, 2011, FTB imposed a late-payment penalty of $224, which appellant subsequently paid in full, as well as the remaining balance due, pursuant to an installment agreement. The late-payment penalty is not at issue in this appeal.

(NPA) dated May 28, 2015. Consistent with the federal audit report, the NPA proposed an increase in appellant's taxable income to $64,945, an increase of $17,191. The NPA proposed additional tax of $1,633, and imposed an accuracy-related penalty of $326.60, plus applicable interest.

7. In a protest letter received by the FTB on June 11, 2015, appellant contended that the disallowed travel expenses of $4,750 were work-related expenses. He asserted that, pursuant to the terms of his H-1B Visa, he was required to travel to Canada to maintain a presence in his home country. Appellant also asserted that he obtained his health insurance from the Canadian section of American Express, which required that he not be out of Canada for more than one month at a time.

8. In a letter dated March 3, 2016, FTB informed appellant that the additional tax and the accuracy-related penalty were based on federal adjustments, that there was no evidence the IRS had cancelled or revised its assessment, and that since California law conforms to federal law for the specific issues involved in appellant's case, FTB's position was that the NPA was correct. FTB requested that appellant forward a copy of any document showing that the IRS had cancelled or revised its determination, by April 7, 2016, or it would affirm the NPA. Appellant did not respond by this deadline.

9. On April 15, 2016, FTB issued a Notice of Action (NOA), affirming its NPA. Appellant then filed this timely appeal.

10. While the appeal was pending, appellant provided (1) an undated schedule showing itemized travel expenses for 2010 that includes the item name, date, reason for the expenditure, amount and, in some cases, invoice numbers of any receipts provided; (2) 22 receipts that purport to support 2010 travel expenses;[4] (3) an undated schedule showing itemized expenses for "Meetings 2010" that includes the item name, the date, the reason for the expenditure, the amount and description of supporting documentation, where provided;[5] and (4) 62[6] receipts that purport to support "Meetings2010."

[4] This is an estimate. Several receipts were copied too lightly to read.

[5] These appear to be mainly receipts for dining in the San Diego area. Appellant claimed deductible meals and entertainment expenses of $2,404 on his Schedule C. Neither the IRS nor FTB disallowed appellant's claimed Schedule C meal expenses. Therefore, we do not address this evidence further.

[6] This is an estimate. Several of the receipts were copied too lightly to read.

11. In his reply brief, appellant conceded that he lacks documentation to support claimed other expenses of $4,835.52;[7] however, he continued to assert that his receipts support $9,387.48 of the Schedule C other expenses, and $4,750 of travel expenses.[8]

12. In its reply brief, FTB agreed to allow the following Schedule C other expenses: (1) business banking charge expenses of $813.12; (2) communications expenses of $1,594; and (3) business expenses of $446.

DISCUSSION

Issue 1 - Has appellant demonstrated error in FTB's proposed assessment, which is based on federal adjustments?

R&TC section 18622(a) provides that taxpayers shall either concede the accuracy of a federal determination or state why it is erroneous. A deficiency assessment based on a federal audit report is presumptively correct, and the taxpayer bears the burden of proving that the determination is erroneous. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Brockett* (86-SBE-109) 1986 WL 22731.)

The evidence in the appeal record shows that the IRS concluded its examination of appellant's 2010 tax return without making any adjustments to the determination on which FTB based its proposed assessment. Appellant's 2010 federal account transcript dated June 15, 2018, includes the notation that it had "[c]losed examination of tax return" on September 1, 2014. The transcript reflects payments made, but no change to appellant's federal determination after September 1, 2014. This appeal was delayed several times to allow appellant sufficient time to obtain documents showing an IRS reconsideration of his federal assessment. In an email dated February 13, 2018, appellant's representative conceded that appellant would be unable to offer additional evidence to show that the IRS had reconsidered or modified appellant's federal assessment. The appeal was in deferred status from May 13, 2016 through March 21, 2018, during which time appellant failed to provide evidence of an adjustment to his federal

[7] In Exhibit C of his reply brief, appellant listed revised claimed Schedule C other expenses as follows: (1) bank charges of $4,244.89 (which closely matches those on the Schedule C); (2) communications expenses of $3,961.51 (an increase from $3,188 shown on the Schedule C); (3) business expenses of $496.45 (rather than $1,495 claimed on the Schedule C); and (4) client gift expenses of $684.99 (rather than $974 shown on the Schedule C).

[8] Respondent's proposed assessment disallows $13,726.55 in Schedule C "other expenses." Therefore, if appellant is only contesting $9,387.48 of those disallowed expenses, the actual conceded amount is $4,339.07 (i.e., $13,726.55 - $9,387.48), rather than the concession amount of $4,835.52 calculated by appellant.

determination. We find that appellant has failed to show that the federal determination upon which FTB relied in making its proposed assessment has been cancelled or revised. Therefore, in order to prevail on this appeal, appellant must show that FTB erred in following the federal determination of appellant's claimed deductions.

Income tax deductions are a matter of legislative grace, and a taxpayer who claims a deduction has the burden of proving by competent evidence that he or she is entitled to that deduction. (*New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435, 440.) To sustain his burden of proof, a taxpayer must be able to point to an applicable deduction statute and show that he came within its terms. (*Appeal of Briglia* (86-SBE-153) 1986 WL 22833.) Unsupported assertions cannot satisfy a taxpayer's burden of proof. (*Appeal of Magidow* (82-SBE-274) 1982 WL 11930.) A taxpayer's failure to produce evidence that is within his or her control gives rise to a presumption that such evidence, if provided, would have been unfavorable to the taxpayer's case. (*Appeal of Cookston* (83-SBE-048) 1983 WL 15434.)

A taxpayer may deduct unreimbursed employee expenses as ordinary and necessary business expenses. (R&TC, § 17201, incorporating by reference Int.Rev. Code (IRC), § 162.) 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." (See also *Roberts v. Commissioner*, T.C. Memo. 2012-197.) By contrast, personal, living, or family expenses are generally nondeductible. (IRC, § 262.) The expenses must be ordinary and necessary business expenditures directly related to the taxpayer's trade or business. (*Deputy v. Du Pont* (1940) 308 U.S. 488, 493-495; Treas. Reg. § 1.162-1(a).)

R&TC section 17201 incorporates IRC section 274(d).[9] That section prohibited a deduction for, among other items, travel and entertainment, meals, and gift expenses unless they were substantiated by adequate records or sufficient corroborating evidence. To qualify for a deduction, the taxpayer must substantiate the claimed expense with adequate records or sufficient evidence to corroborate the taxpayer's own statement as to: (1) the amount of the expense or other item; (2) the time and place of the travel, entertainment, amusement, recreation, or use of the property, or the date and description of the gift; (3) the business purpose of the

[9] All references to IRC section 274 are to the version of that statute that was in effect during the 2010 taxable year.

expense or other item; and (4) the business relationship to the taxpayer of the persons entertained or receiving the gift. (IRC, § 274(d).)

Travel Expenses

Taxpayers may deduct all ordinary and necessary travel expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business. (IRC, § 162(a)((2).) Travel claims are subject to heightened requirements to substantiate various expenses, including travel, meal, and entertainment expenses, with "adequate records" for travel expenses. (IRC, § 274(d); see also Treas. Reg. § 1.274-5T(c)(2)(i).)

Appellant claimed travel expenses of $4,750 on his Schedule C, which FTB disallowed in full. Appellant provided a spreadsheet detailing the time and place of each expense, and the business purpose for the expense. Appellant argues that he can establish his travel expenses pursuant to Treasury Regulation part 1.274-5T(c)(3) by his own written statement containing specific information in detail and by other corroborative evidence, such as documents. However, appellant provided substantiating documentation (receipts) for small amounts, such as airport meals, parking and taxis. Other receipts that were provided are illegible and cannot be used to substantiate appellant's claims. Appellant asserts that he attempted to obtain credit card statements from the Canadian section of American Express, but the company does not retain records going back to 2010.[10] Appellant provided no receipts for the bulk of the claimed travel expenses, and with respect to those has failed to meet the heightened requirements of IRC section 274(d) and Treasury Regulation section 1.274-5T(c)(2)(i).

For other claimed travel expenses, appellant provided receipts showing the expenses, and the times and the places of the expenses, but there is no evidence the expenses were incurred in the pursuit of his management consulting business. Moreover, because appellant acknowledged that he was required to return frequently to Canada because of his H-1B Visa status, and because of the requirements of the health insurance he obtained from American Express in Canada, some of appellant's trips may have been for personal rather than business purposes.

[10] Appellant makes this assertion in a reply brief on appeal, filed in 2017. However, appellant was put on notice that he would need to substantiate his claimed expenses no later than when the IRS ended its examination of his return and assessed additional tax in 2014.

Based on the foregoing, appellant has failed to show that FTB erroneously disallowed appellant's claimed travel expenses of $4,750 as Schedule C expenses.

Gift Expenses

Deductions for gifts made to any individual during a taxable year may not exceed $25. (IRC, § 274(b)(1); Treas. Reg. § 1.274–3(a).) A "gift" is defined as any item that could be excluded from the gross income of the recipient under IRC section 102. (IRC, § 274(b)(1).)

Appellant has not established that the deduction of $974 he claimed as gift expenses did not exceed $25 spent on any one individual during 2010. Furthermore, appellant has not satisfied the heightened requirements for proving his claimed client gift expenses. On appeal, appellant reduced his claimed client gift expenses to $684.99, which consists of a single item for a wedding gift for a colleague. Appellant has provided no evidence that would support a deduction for this gift to one individual. Therefore, we find that appellant has failed to show that FTB erroneously disallowed appellant's claimed client gift expense deductions of $974 under Schedule C other expenses.

Bank Charge Expenses

Appellant claimed a deduction for client bank charges of $4,244 on his Schedule C. FTB subsequently allowed a deduction of $813.12 for bank service fees. A schedule of bank expenditures provided by appellant shows that the remaining $3,431.77 was associated with a "Personal Account." Personal, living, or family expenses are generally nondeductible. (IRC, § 262; Treas. Reg. § 1.262-1(a).) Appellant has not provided any legal authority or any evidence showing that these bank service charges were business-related and therefore deductible. Therefore, we find that appellant has failed to establish that FTB erroneously disallowed claimed bank service charges of $3,431.77 as Schedule C other expenses.

Communications Expenses

Appellant claimed a deduction for communications expenses of $3,188 on his Schedule C, which FTB disallowed. Appellant claimed he incurred communications expenses consisting of internet and telephone expenses, and cellular expenses. Subsequently, FTB agreed to allow appellant a deduction for communications expenses of $1,594. Without any evidence of statements, bills, cancelled checks or credit card statements, appellant has not shown that any of

these disallowed communication expenses constitute ordinary and necessary expenses paid or incurred in pursuit of appellant's management consulting business. Therefore, we find that appellant has failed to show that FTB erroneously disallowed some of appellant's claimed communications expenses.

Business Expenses

Appellant claimed a deduction for business expenses of $1,495 on his Schedule C, which FTB disallowed in its entirety. In his reply brief, appellant instead claimed deductions of $496.45 for business expenses. On appeal, FTB agreed to allow appellant to deduct business expenses of $446. Therefore, the amount at issue in this appeal appears to be only $50.45. Without knowing more about appellant's management consulting business or having any statements, bills, cancelled checks or credit card statements, appellant has not established that any of these disallowed business expenses constitute ordinary and necessary expenses paid or incurred during the taxable year in pursuit of appellant's management consulting business. Therefore, we find that appellant has failed to show that FTB erroneously disallowed claimed business expenses of $50.45.

The *Cohan* Rule

Because appellant was unable to obtain all the evidence necessary to support his claim, he urges us to allow his estimates for unproven deductions under the rule in *Cohan v. Commissioner* (2d Cir. 1930) 39 F.2d 540 (*Cohan*). The rule in *Cohan* (the *Cohan* Rule) was adopted when the famous theatrical producer George M. Cohan testified at trial that he had spent substantial sums of money on travel and entertaining actors, employees, and drama critics in furtherance of his theatrical production business. Cohan could not substantiate by records his actual expenditures but instead estimated the amounts in his testimony. The court held that, where a taxpayer has established that he or she has incurred an expense for which a deduction may properly be claimed, but is unable to document the exact amount of the expense, a court may make a reasonable estimate of the deduction in certain circumstances, "bearing heavily" against the taxpayer whose inexactitude is of his or her own making. (*Id.* at pp. 543-44.)

For a court to estimate the amount of expenses under the *Cohan* Rule, the court must have some basis upon which an estimate may be made. (*Vanicek v. Commissioner* (1985) 85 T.C. 731, 742-43.) Without such a basis, any allowance would amount to unguided generosity.

(*Williams v. United States* (5th Cir.1955) 219 F.2d 523, 560-561.) A court may estimate some expenses, but only if the taxpayer provides at least some evidence to support an estimate, and the court is convinced that he or she incurred them. (*Cohan, supra*, 39 F.2d at pp. 543–44.) However, the provisions of IRC section 274(d) supersede the *Cohan* Rule with respect to certain expenses at issue here. (*Becker v. Commissioner*, T.C. Memo. 2018-69.) Specifically, the *Cohan* Rule cannot be applied with respect to appellant's claimed deductions for travel expenses and client gift expenses. **(**Treas. Reg. § 1.274-5T(a).)

Regarding the claimed bank charges, communications expenses, and business expenses, we need not apply the *Cohan* Rule. On appeal, FTB has already allowed additional claimed expenses that are partially based on reasonable assumptions from the evidence provided (e.g., half of all claimed communications expenses), in addition to allowing all deductions that are directly supported by evidence provided. As such, FTB has already applied the *Cohan* Rule in making a reasonable estimate of appellant's claimed business expenses, and we find that no further application of the *Cohan* Rule is warranted. FTB did not err in disallowing any further Schedule C other expenses.

Issue 2 – Has appellant demonstrated that he is entitled to abatement of the accuracy-related penalty?

When FTB assesses an accuracy-related penalty based on a federal action, the assessment of the penalty is presumptively correct. (*Appeal of Abney* (82-SBE-104) 1982 WL 11781.) R&TC section 19164, which incorporates the provisions of IRC section 6662, provides for an accuracy-related penalty of 20 percent of an underpayment. IRC section 6662(b) provides, in part, that the penalty applies to the portion of the underpayment attributable to: (1) negligence or a disregard of rules and regulations; or (2) any substantial understatement of income tax. IRC section 6662(c) defines "negligence" to include "any failure to make a reasonable attempt to comply" with the provisions of the IRC. The term "disregard" is defined to include any "careless, reckless, or intentional disregard." (*Id*.) IRC section 6662(d)(1) provides that a substantial understatement of tax exists if the amount of the understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000. An "understatement" means the excess of the amount required to be shown on the return for the taxable year over the tax imposed, reduced by any rebate. (IRC, § 6662(d)(2).)

According to appellant's 2010 federal account transcript, the IRS imposed an accuracy-related penalty. Appellant reported a total tax of $6,150 on his 2010 federal return. The IRS assessed additional tax of $4,300 based on a determination that the correct amount of tax required to be shown on the federal return was $10,450. Because the understatement is less than the greater of $5,000 or $1,045 (10 percent of the tax required to be shown on the federal return), the IRS imposed the penalty based on negligence or disregard for rules and regulations. Appellant's underreported state tax also did not meet the thresholds to determine that he substantially understated his tax. Accordingly, FTB imposed the accuracy-related penalty due to appellant's negligence or disregard for rules or regulations.

There are three exceptions to the imposition of the accuracy-related penalty. The taxpayer bears the burden of proving any defenses to the imposition of the accuracy-related penalty. (*Recovery Group, Inc. v. Commissioner*, T.C. Memo. 2010-76.)

None of the statutory exceptions to the imposition of the accuracy-related penalty apply here. Appellant does not contend, and the evidence does not show, that there was substantial authority for the tax treatment of any disallowed item. (See IRC, § 6662(d)(2)(B).) Nor has he shown any disallowed item's tax treatment was adequately disclosed, or that he had a reasonable basis for the tax treatment of such item. (See *ibid*; Treas. Reg. § 1.6662- 3(c)(1).) He simply failed to substantiate his claimed deductions. In addition, appellant provides no argument or evidence establishing that he acted reasonably and in good faith in determining his 2010 tax liability. (See IRC, § 6664(c)(1); Treas. Reg. §§ 1.6664-1(b)(2) and 1.6664-4.)

The accuracy-related penalty imposed by FTB based on the IRS's imposition of the federal accuracy-related penalty for negligence or disregard of the rules or regulations is presumed correct. The IRS did not abate the federal penalty. On appeal, appellant merely contends that he provided documentation that shows that his underpayment was not negligent or in disregard of rules or regulations. He does not show the steps he took to accurately state his income and deductions. Accordingly, appellant has failed to establish that the accuracy-related penalty should be abated. However, FTB must also reduce the amount of the accuracy-related penalty consistent with the reduction of the tax determined in this appeal.

HOLDINGS

1. Appellant has failed to demonstrate error in FTB's proposed assessment (as adjusted by FTB on appeal), which is based on federal adjustments.
2. Appellant has not established that the accuracy-related penalty should be abated; however, the accuracy-related penalty should be reduced consistent with the reduction of the tax determined in this appeal.

DISPOSITION

Based upon the foregoing, the action of FTB is modified, as conceded by FTB, to allow previously disallowed Schedule C other expenses of $2,853.12. The accuracy-related penalty must be reduced consistent with the reduction of the tax determined in this appeal. Otherwise, FTB's action is sustained.

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Teresa A. Stanley
Administrative Law Judge

We concur:

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John O. Johnson
Administrative Law Judge

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Grant S. Thompson
Administrative Law Judge