OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	)	OTA Case No. 18042717
	)	
CHRISTOPHER J. WOOD	)	Date Issued: July 8, 2019
	)	
	)	
	)	

OPINION

Representing the Parties:

For Appellant: Pamela J. Sonnier, EA

For Respondent: Andrew Amara, Tax Counsel III

For Office of Tax Appeals: Josh Lambert, Tax Counsel

K. GAST, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, Christopher J. Wood (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing an assessment of tax of $1,557 and a late-filing penalty of $389.25, plus interest, for the 2015 tax year. Appellant waived his right to an oral hearing. Therefore, this matter is being decided based on the written record.

ISSUE

Did appellant derive income from a California source in 2015 that required him to file a California nonresident income tax return and pay California tax?

FACTUAL FINDINGS

1. For the tax year at issue, appellant was a California nonresident and resided in Texas. He worked as both an employee and independent contractor for an unrelated, third-party company called Christopher Konrad Consulting, LLC (Konrad).
2. As an independent contractor, appellant describes his "business as a subcontractor and [his] trade/profession/work as a designer." It is undisputed that, during the year at issue, he operated his design business as a sole proprietorship.

3. On March 2, 2015, appellant, in his capacity as an independent contractor/sole proprietor, entered into a Professional Services Consulting Agreement (Agreement) with Konrad.

   a. The Agreement states that Konrad, a California LLC, had its principal place of business in California, and appellant, a Texas sole proprietor,[1] had his principal place of business at his home office in Texas.

   b. The recitals section provides, in relevant part:

      i. "Konrad provides strategy and design for companies that want to create software and technology products, with an emphasis in understanding the way customers think, emote and behave in developing the creative process."

      ii. "Konrad is in the process of submitting various bid proposals . . . to companies seeking assistance in the development and creative process of their products with anticipated periods of performance of several months."

      iii. "[Appellant] provides a full set of integrated services from operational strategy, through implementation, to support and optimization."

      iv. "Konrad wishes to retain [appellant] to assist Konrad on a non-exclusive basis in the Bid Proposal process with various companies and to provide such Services to Konrad..... "

   c. Exhibit A of the Agreement lists appellant's scope of services. This exhibit contains the following relevant information:

      i. Appellant is to complete a project in which "User Experience design services will be provided to assist clients in designing the user experience of their products and services." The "[d]esign services will be applied to a variety of clients and products including but not limited to BMC MyIT, SmartIT and ITSM."

[1] We note that Section 10 of the Agreement provides, in relevant part, that appellant's relationship with Konrad "shall be that of an independent contractor and nothing in [the] Agreement shall be deemed to create a partnership, joint venture or employer/Consultant relationship." This provision is consistent with our factual finding above—i.e., that appellant was an independent contractor with respect to his design business and operated as such under the Agreement and not as an employee of Konrad.

ii. The exhibit lists five detailed deliverables appellant must provide related to these design services.[2]

iii. The exhibit goes on to state that appellant's services are to be performed during a three-month performance period, starting on March 9, 2015, and ending on May 29, 2015, or as otherwise agreed to by appellant and Konrad.

iv. The exhibit further states appellant's services are to be performed at his home office in Texas.

d. Exhibit B of the Agreement provides that Konrad will pay appellant a "firm-fixed fee" in the amount of $48,000.[3]

e. Appellant also submitted an attachment to the Agreement entitled "VII. Contractor Personnel." In this attachment, appellant agrees to various obligations imposed on him by Konrad's customer, BMC, including, e.g., appellant's agreement to comply with the BMC Professional Conduct Policy and Code of Ethics in connection with his work for BMC. Appellant signed the attachment as "subcontractor."[4] The attachment provides that "[c]ontractor [presumably Konrad] shall provide consulting, development, support and/or other employees or subcontractors [i.e., appellant], as required or necessary, to perform the [s]ervices."

4. Konrad issued appellant a Form 1099-MISC that reported the $48,000 as compensation for his services.[5] Konrad also paid appellant W-2 wages of approximately $90,000 in his

[2] These deliverables are described in the Agreement in the following technical terms: (1) design concepts and sketches that show possible solutions to any given user problem; (2) storyboards and wireframe that communicate the organization of "UI" elements for the purpose of defining user's interactions with the application; (3) high-fidelity visual "comps" that define the type, color, layout, the overall design style of the user interface; (4) design specifications that provide a rich definition of the design elements of, for example, pixel level spacing, control sizes, and positioning; and (5) assets that can be used by development to implement the design.

[3] The fee appears to have been paid in six equal installments over the course of six "milestone/deliverable" dates that covered the three-month performance period under the Agreement.

[4] Only appellant's signature appears on this contract. Neither Konrad nor BMC signed it.

[5] The payer information lists Konrad's California business address, while the recipient information lists appellant's Texas office address.

capacity as an employee of Konrad.[6] Appellant did not file a California nonresident income tax return for the 2015 tax year.[7]

5. Subsequently, FTB obtained information indicating appellant received a Form 1099-MISC issued by Konrad for 2015 that reported the $48,000 of income paid to appellant. FTB concluded this amount was derived solely from California sources and issued to appellant a Request for Tax Return for the 2015 tax year. Appellant timely responded: "No business performed in California. No tax due."[8]

6. FTB then issued a Notice of Proposed Assessment (NPA) for the 2015 tax year. The NPA reflected an estimated total adjusted gross income (AGI) of $48,000, which was based solely on the Form 1099-MISC income he received from Konrad. It proposed a tax liability and a late-filing penalty, plus interest, in the amounts noted above.[9] The NPA did not tax appellant's other income, such as his W-2 wages of about $90,000 that he earned as Konrad's Texas-based employee for services unrelated to those he performed under the Agreement.

7. Appellant timely protested the NPA. He contended that none of the services under the Agreement were performed in California. Rather, they were performed solely at his home office in Texas. As support, he submitted the Agreement, its attachments, and numerous other documents—including electric and internet bills, as well as emails[10]

[6] The record does not contain a copy of appellant's 2015 federal income tax return.

[7] Appellant's 2015 federal transcripts also show he earned W-2 wage income of $16,000 as an employee of another unrelated business that appears to be based in New York, but it is unclear whether he filed a New York nonresident income tax return. In addition, we note appellant likely would not have owed any income/franchise taxes to Texas, his state of residence. This is because Texas does not impose a personal income tax or appear to subject non-LLC sole proprietorships to the Texas franchise tax. In short, the record does not disclose whether appellant (and/or his independent contractor business) filed any 2015 state or local income/franchise tax returns and paid tax on his income, including the $48,000 at issue here.

[8] He also indicated that for 2015, he was married (and presumably filed a joint 2015 federal tax return with his wife), he was under 65 years of age and had no dependents, and his total gross income from all sources was $156,221.

[9] We note that appellant was married during 2015, and it is unclear why FTB's NPA computed an assessment as if he were single. In any event, for the 2015 tax year, appellant's worldwide income (i.e., $156,221) exceeded the minimum filing status threshold amounts sufficient to trigger a return obligation for individuals who are either married or unmarried and are under 65 years of age with no dependents. (R&TC, § 18501(a) & (d); see also FTB 2015 Form 540NR Booklet.)

[10] One of these emails from Konrad indicates a meeting location of the host (i.e., Konrad) as being in San Francisco, California. There is no indication, however, that appellant attended this meeting in person.

indicating he was at his home office in Texas when he performed the subject services. This evidence, appellant asserted, showed he did not have a 2015 California filing obligation.[11]

8. FTB issued a Notice of Action, affirming the NPA. This timely appeal followed.

9. In his appeal letters, appellant continues to maintain that FTB's assessment is invalid for the same reasons he asserted in his protest letter. However, he also asserts, in relevant part, that "[t]he nature of the work that I do requires that I design for extended periods of time and then present these design in remote meetings (online) to stakeholders. These stakeholders were primarily located in Vancouver, Canada."

10. In its brief, FTB counters that it is irrelevant that appellant performed all his services under the Agreement from his home office in Texas. Rather, FTB contends that starting in 2013, California abandoned the prior rule sourcing service income from a trade or business based on the location where the service was performed in favor of a rule sourcing such income based on the location where the customer (here, Konrad) received the benefit of appellant's services. Since, FTB asserts, Konrad only has a business location in California, it only could have received the benefit of appellant's services in this state.[12] Accordingly, because appellant received at least $1 of income from California sources and his gross income from all sources exceeds the threshold filing levels for 2015, FTB concludes he must file a California nonresident income tax return and pay California tax.

[11] The record is silent as to how appellant formed a business relationship with Konrad, where business negotiations and execution of the Agreement took place, whether, in general, he solicited any business from or advertised his design services in California, and whether—despite not being physically present in California to perform the services under the Agreement—he ever was physically present in California during 2015 for any other purpose related to his independent contractor/design services.

[12] FTB submitted public records from LexisNexis to support its factual assertion that, for the 2015 tax year, Konrad operated its business from a location(s) exclusively in California. However, these records also list appellant's home office in Texas as one of Konrad's business locations. This Texas location may have been listed because appellant was also an employee of Konrad. In addition, the record does not indicate how Konrad was taxed for California income tax purposes, and/or whether it filed a Schedule R with its California return such that it was an apportioning trade or business conducting operations within and without the state.

DISCUSSION

A. Burden of Proof

R&TC section 19087(a) provides that if any taxpayer fails to file a return, FTB at any time "may make an estimate of the net income, from any available information, and may propose to assess the amount of tax, interest, and penalties due."

If FTB proposes a tax assessment based on an estimate of income, FTB's initial burden is to show why its assessment is reasonable and rational. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Myers* (2001-SBE-001) 2019 WL 1187160.) Federal courts have held that the taxing agency need only introduce some evidence linking the taxpayer with the unreported income. (See *Rapp v. Commissioner* (9th Cir. 1985) 774 F.2d 932, 935.) When a taxpayer fails to file a valid return, FTB's use of income information from various sources to estimate a taxpayer's taxable income is a reasonable and rational method of estimating taxable income. (See *Palmer v. Internal Revenue Service* (9th Cir. 1997) 116 F.3d 1309, 1313; *Appeals of Tonsberg* (85-SBE-034) 1985 WL 15812.) Once the FTB has met its initial burden, its determination is presumed correct, and the taxpayer has the burden of proving it is wrong. (*Todd v. McColgan, supra*; *Appeal of Myers, supra*.)

For the following reasons, we conclude FTB's proposed assessment is not reasonable and rational.

B. Applicable Law

California requires "[e]very individual taxable" under the Personal Income Tax Law (PITL)[13] (commencing with section 17001) to make a return to FTB, if the individual derives gross income or AGI from all sources in excess of the applicable filing threshold amount. (R&TC, § 18501(a)(1)-(4).) It is undisputed that appellant's service income from Konrad of $48,000 exceeds the applicable filing threshold amount. However, appellant still must be an "individual *taxable*" under the PITL to be required to file a return.

California residents are subject to tax on their entire taxable income, regardless of where that income is earned or sourced. (R&TC, § 17041(a)(1).) However, nonresidents, such as appellant, are taxed only on taxable income "derived from sources within" California, which, as

[13] The PITL is found under Part 10 of Division 2 of the Revenue and Taxation Code.

relevant here, is determined under R&TC section 17951 and subsequent provisions. (R&TC, § 17041(b) & (i)(1)(B).)

R&TC section 17951(a) provides that, for purposes of computing the taxable income of a nonresident, gross income includes only income which is derived from sources within California. (See also Cal. Code Regs., tit. 18, (Regulation) § 17951-1(a).) R&TC section 17954, in turn, provides that gross income from sources within and without California shall be allocated and apportioned under rules and regulations prescribed by FTB. Regulation section 17951-4, which implements and interprets R&TC sections 17041(i)(1) and 17954, deals with nonresident sourcing provisions when income is derived from a business, trade, or profession. (See also Regulation § 17951-2.) The question before us is whether, under these provisions, appellant has California source income.

C. Regulation section 17951-4(c)

Regulation section 17951-4(c) provides income-sourcing provisions for when a nonresident's business, trade, or profession is a sole proprietorship that conducts a unitary business with operations within and without California. Under its provisions, when a sole proprietorship conducts a unitary business within and without California, its income is apportioned to California under the statutory apportionment provisions of the Uniform Division of Income for Tax Purposes Act (the UDITPA, R&TC sections 25120-25139) that are applicable to corporations.

Regulation section 17951-4(c) can be broken down into four conditions that must be satisfied for a nonresident taxpayer to have California source income and a filing requirement: (1) the taxpayer must be conducting business as a sole proprietorship; (2) the taxpayer's business must be conducted within and without California; (3) the taxpayer must be carrying on a unitary business; and (4) the taxpayer must derive California source income.

Here, it is undisputed that appellant, a nonresident, is conducting business as a sole proprietorship. Therefore, condition (1) has been met. However, we conclude below that appellant did not derive California source income, and therefore condition (4) has not been met. Accordingly, our analysis ends there, and we do not need to address whether conditions (2) or (3) have been met.

D. California's Market-Based Sales Factor Sourcing Provisions

Regulation section 17951-4(c)(2) contains rules for determining how much of a nonresident sole proprietor's business income is subject to tax in California.[14] Specifically, Regulation section 19751-4(c)(2) provides that "[t]he amount of such business income derived from sources within [California] shall be determined in accordance with the provisions of the apportionment rules of [the UDITPA], [s]ections 25120 to 25139, inclusive, Revenue and Taxation Code, and the regulations thereunder . . . ." Thus, Regulation section 17951-4(c)(2) treats businesses conducted through sole proprietorships the same as businesses conducted through corporations or other business entities subject to the UDITPA.

For the 2015 tax year, most multistate taxpayers were required to apportion business income by an apportionment formula that consists of a single-sales factor. (R&TC, § 25128.7.) The sales factor is a fraction, where the numerator is the taxpayer's total sales in California during the taxable year and the denominator is the taxpayer's total sales everywhere during the taxable year. (R&TC, § 25134; see also Regulation § 25134.)

For purposes of determining what amount is included in the numerator of the sales factor, R&TC section 25136 governs the assignment of receipts from sales other than sales of tangible personal property, such as service revenue. R&TC section 25136(a)(1) provides that "[s]ales from services are in [California] to the extent the purchaser of the service received the benefit of the services in [California]." Under R&TC section 25136(b)'s statutory grant of authority, FTB promulgated Regulation section 25136-2, which provides detailed market-based sales factor sourcing provisions that implement and interpret R&TC section 25136.

Consistent with the statute, Regulation section 25136-2(c) provides that "[s]ales from services are assigned to [California] to the extent the customer of the taxpayer receives the

[14] We note that it appears Regulation section 17951-5 is inapplicable, because appellant does not appear to be covered by any of its provisions. Subdivisions (a)(1) and (b) of the regulation are inapplicable because, under the Agreement, appellant is not an employee, and subdivision (a)(2) is inapplicable because appellant is not an actor, singer, performer, entertainer, wrestler, boxer, or similar entertainer. With regard to subdivision (a)(3), there is no evidence that appellant is providing services as an attorney, physician, accountant or engineer, and we do not believe one would ordinarily consider a designer and consultant to be an "attorney[], physician[], accountant[], engineer[], etc." While nonresident doctors and lawyers may admittedly operate as sole proprietorships, appellant is not a doctor or lawyer, and we do not believe that Regulation section 17951-5(a)(3) applies to his business.

benefit of the service in [California]."[15] "Benefit of a service is received" is defined as "the location where the taxpayer's customer has either directly or indirectly received value from delivery of that service." (Regulation § 25136-2(b)(1).) Regulation section 25136-2(c)(2) provides that where a corporation or other business entity is the taxpayer's customer, such as in this case, receipt of the benefit of the service shall be determined under the following cascading rules:

> (A) The location of the benefit of the service shall be presumed to be received in this state to the extent the contract between the taxpayer [i.e., appellant] and the taxpayer's customer [i.e., Konrad] or the taxpayer's books and records kept in the normal course of business, notwithstanding the billing address of the taxpayer's customer, indicate the benefit of the service is in this state. This presumption may be overcome by the taxpayer or [FTB] by showing, based on a preponderance of the evidence, that the location (or locations) indicated by the contract or the taxpayer's books and records was not the actual location where the benefit of the service was received.
>
> (B) If neither the contract nor the taxpayer's books and records provide the location where the benefit of the service is received, or the presumption in subparagraph (A) is overcome, then the location (or locations) where the benefit is received shall be reasonably approximated.
>
> (C) If the location where the benefit of the service is received cannot be determined under subparagraph (A) or reasonably approximated under subparagraph (B), then the location where the benefit of the service is received shall be presumed to be in this state if the location from which the taxpayer's customer placed the order for the service is in this state.
>
> (D) If the location where the benefit of the service is received cannot be determined pursuant to subparagraphs (A), (B), or (C), then the benefit of the service shall be in this state if the taxpayer's customer's billing address is in this state.

A threshold question is whether appellant's customer for purposes of these service sourcing provisions is Konrad or Konrad's customer, BMC. Although the provisions appear to focus on the location where a taxpayer's *direct* customer received the benefit of the services, there may be circumstances where the benefit of the taxpayer's services will be received by the

[15] "Service" is defined as "a commodity consisting of activities engaged in by a person for another person for consideration. The term 'service' does not include activities performed by a person who is not in a regular trade or business offering its services to the public . . . ." (Regulation § 25136-2(b)(8).) Here, appellant is a self-described designer who, through his sole proprietorship, provides "a full set of integrated services from operational strategy, through implementation, to support and optimization." Appellant's own description of his business, as well as his provision of services to Konrad and Konrad's customer, BMC—both of which are unrelated companies—suggest that his business provides services to the public for consideration.

customer's own customer.[16] We believe that such a situation exists here. Under the Agreement, appellant's direct customer is Konrad, but, upon closer examination, it appears that appellant's services are being provided for the benefit of Konrad's customer, BMC. The benefit of appellant's "User Experience" services is assisting BMC in designing its products and services to help BMC promote and sell them.

Turning to the issue of the location where BMC received the benefit of appellant's services, we are unable to apply the first cascading rule under subparagraph (A) of Regulation section 25136-2(c)(2). Neither the Agreement nor its attachments, including the BMC contract appellant signed, entitled "VII. Contractor Personnel," specify the location where BMC received the benefit of appellant's services.

However, under subparagraph (B), we are able to reasonably approximate the location where Konrad received the benefit of appellant's services to the locations of BMC. "Reasonably approximated" means, in relevant part, "considering all sources of information other than the terms of the contract and the taxpayer's books and records kept in the normal course of business, the location of the market for the benefit of the services . . . is determined in a manner that is consistent with the activities of [Konrad] to the extent such information is available to [appellant]." (Regulation § 25136-2(b)(7).) In his appeal letter, appellant asserts, in relevant part, that "[t]he nature of the work that I do requires that I design for extended periods of time and then present these designs in remote meetings (online) to stakeholders. These stakeholders were primarily located in Vancouver, Canada." Appellant provided "online meeting invites and meeting acceptance emails" to support this assertion, and FTB has not contested it. Furthermore, FTB does not allege—much less show—that BMC is a California-based business, or that appellant provided services that benefited BMC in California.

For these reasons, it was not reasonable and rational for FTB to rely on Regulation section 25136-2(c)(2)(A) or (B) to source all of appellant's $48,000 of service income to

[16] This view is consistent with examples 4 and 5 of Regulation section 25136-2(c)(2)(E) (where sales from a website's advertising services for its direct customers are sourced to the location from where the advertisement is viewed and/or clicked on by ultimate customer viewers). It is also consistent with FTB Chief Counsel Rulings 2015-03 (Dec. 31, 2015) and 2017-01 (April 7, 2017). While these rulings are not binding on OTA, we agree with their underlying logic. They stand for the proposition that since Regulation section 25136-2 makes a distinction between marketing and non-marketing intangibles—sourcing income from the former to the location of the ultimate customer (i.e., the taxpayer's customer's customer), and the latter to the location where the direct customer uses the intangible in its business—by analogy, the same should be true for marketing services, even though the regulation does not expressly make a similar distinction.

California simply because the Agreement indicates Konrad has a billing address in California.[17] Accordingly, because appellant did not derive California source income, he is not required to file a 2015 nonresident return.

HOLDING

Appellant did not derive income from a California source in 2015 that required him to file a California nonresident income tax return and pay California tax. Consequently, appellant is also not subject to the late-filing penalty.

DISPOSITION

FTB's proposed assessment is reversed in full.

DocuSigned by:
Kenneth Gast
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Kenneth Gast
Administrative Law Judge

We concur:

DocuSigned by:
Teresa A. Stanley
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Teresa A. Stanley
Administrative Law Judge

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

[17] Regulation section 25136-2(c)(2)(A) itself expressly forbids reliance on the customer's billing address, and Regulation section 25136-2(c)(2)(B) requires one to use a reasonable approximation, not the customer's billing address. When the other three sourcing rules are not determinative, Regulation section 25136-2(c)(2)(D) does permit reliance on the customer's billing address, but FTB does not assert this rule as a basis for its proposed assessment.