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2019 – OTA – 333
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18010918
JAMES H. NICHOLAS AND YVONNE M. NICHOLAS	) Date Issued: October 1, 2019

OPINION

Representing the Parties:

For Appellants: James H. Nicholas and Yvonne M. Nicholas

For Respondent: David Muradyan, Tax Counsel III

Office of Tax Appeals: William J. Stafford, Tax Counsel III

J. MARGOLIS, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, James H. Nicholas and Yvonne M. Nicholas (appellants) appeal the actions of respondent Franchise Tax Board (FTB) denying their protests against proposed tax assessments for 2006 and 2007.

ISSUE

Whether appellants have demonstrated error in FTB's proposed assessments, which are based on information received from the Internal Revenue Service (IRS).

FACTUAL FINDINGS

1. Appellants filed their 2006 and 2007 California Resident Income Tax Returns, which were based, in part, upon the income and deductions reported on their federal income tax returns for the same years.
2. The IRS audited appellants' federal income tax returns for 2006 and 2007. The audit resulted in the IRS adjusting appellants' income and deductions, determining tax deficiencies and proposing accuracy-related penalties for negligence.

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3. Appellants petitioned the United States Tax Court for a redetermination of the federal liabilities proposed by the IRS. That proceeding did not result in any changes to the IRS determination, except the accuracy-related penalty for 2006 was eliminated. Ultimately, appellants executed a stipulated decision document in which they conceded all the adjustments the IRS had proposed, other than the accuracy-related penalty for 2006.
4. The federal adjustments have become final federal assessments. Appellants did not notify FTB of the federal adjustments, although the IRS did.
5. Most of the IRS's adjustments for 2006 and 2007 related to disallowed deductions appellants claimed with respect to two Schedule C businesses. On appellants' 2007 federal income tax return, those businesses were identified as "office and apartment property" and "office and apartment rental."[1] In their filings in this appeal, appellants have described their businesses as "rent[ing out] a separately constructed guest house on their property for tax years 2006 and 2007."
6. According to appellants' 2007 federal tax return, both businesses—and appellants' personal residence—were located on a single 20-acre parcel of land in a rural area approximately 35 miles from Santa Maria and Santa Barbara, California. Unit A of the parcel was appellants' personal residence and Unit B was the guest house and location of appellants' Schedule C businesses.
7. Appellants reported no gross receipts from either of their Schedule C businesses on their 2006 and 2007 tax returns.
8. According to the information provided by the IRS (IRS FEDSTAR Data Sheets, an IRS Form 4549B, an IRS Revenue Agent's Report, and a Tax Court decision document), the IRS adjustments were as follows.[2]
    a. For 2006, the IRS:
        i. disallowed Schedule C "Other" expense of $2,461;
        ii. disallowed Schedule C "Repairs and Maintenance" expense of $5,719;
        iii. disallowed Schedule C "Depreciation 179" expense of $21,470;
        iv. disallowed Schedule C "Contract labor" expense of $1,029;

[1] The parties have not provided us with a copy of appellants' 2006 federal return.

[2] We aggregated the items in the list of disallowances from appellants' two separately-reported Schedule C businesses since they to relate to the same activity, to wit, appellants' purported rental activity of a portion of their residential property.

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v. disallowed Schedule C "Utilities" expense of $1,812;

vi. disallowed Schedule C "Taxes and Licenses" expense of $125;

vii. disallowed Schedule C "Rent/Lease (Equip)" expense of $278;

viii. disallowed Schedule C "Office" expense of $129;

ix. disallowed Schedule C "Car and Truck" expense of $4,196;

x. determined additional dividend income of $20;

xi. disallowed itemized deductions of $207; and

xii. reduced adjusted gross income by $71.

b. For 2007, the IRS:

i. disallowed Schedule C "Repairs and Maintenance" expense of adjustment of $2,045;

ii. disallowed Schedule C "Depreciation 179" expense of $24,533;

iii. disallowed Schedule C "Other" expense of $481;

iv. disallowed Schedule C "Utilities" expense of $2,511;

v. disallowed Schedule C "Taxes and Licenses" expense of $135;

vi. disallowed Schedule C "Rent/Lease (Equip)" expense of $245;

vii. disallowed Schedule C "Car and Truck" expense of $5,447;

viii. disallowed itemized deductions of $172; and

ix. determined underreported income from a state tax refund of $490.

9. The IRS documentation indicates that the Schedule C expenses listed above were disallowed by the IRS on the following three grounds:

a. Appellants had not shown that their claimed Schedule C expenses were incurred in "carrying on a trade or business" within the meaning of Internal Revenue Code (IRC) section 162.

b. Appellants may not deduct personal living or family expenses. (See IRC, § 262).

c. Appellants had not established that the business expenses shown on their return were paid or incurred during the taxable year and that the expenses were ordinary and necessary to their business.

10. On February 28, 2014, FTB issued Notices of Proposed Assessment (NPAs) to appellants that incorporated the IRS adjustments to the extent they were applicable for California tax purposes. FTB's NPA for 2006 increased appellants' California taxable income by

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$37,168 and proposed a tax deficiency of $3,171, plus applicable interest. FTB's NPA issued for 2007 increased appellants' California taxable income by $35,397 and proposed a tax deficiency of $2,982, plus applicable interest.[3]

11. Appellants protested the NPAs with FTB. In their protests, they initially claimed, "I don't know the basis for this amount. Please describe." Appellants subsequently provided FTB with various invoices and schedules, which they contend substantiate their deductions.

12. Appellants also contended at protest (and in this appeal) that the IRS disallowed their Schedule C deductions only because they did not report any rental income. Appellants state that "[t]here was never any dispute regarding the expenses and depreciation associated with the property, only [regarding] the question of it being a business activity engaged in for profit." We reject this contention as being unsupported by, and inconsistent with, the documentary evidence in this appeal (in particular, the IRS Revenue Agent's Report). That documentary evidence shows that the IRS raised three separate and independent grounds for its disallowances. Appellants also claim that their inability to obtain tenants for their rental property was the result of the financial crisis (the Great Recession), which allegedly destroyed the market for appellants' rental unit.

13. FTB denied appellants' protests and issued Notices of Action (NOAs) affirming the NPAs in full.

14. Appellants timely appealed the NOAs to our predecessor, the State Board of Equalization. In their appeal letter, appellants contested only the Schedule C disallowances, and reiterated the arguments made in their protests. Appellants also provided hundreds of pages of documentation pertaining to the amounts deducted. The documents consist primarily of receipts for landscaping, construction materials, construction labor, truck repair, homeowners' association dues, furniture, pest control, irrigation supplies, computer equipment, software, office supplies, and various utilities (water, electricity, propane, garbage service, telephone, and internet). However, appellants have provided no documentation showing that they attempted to rent out the property during 2006 or 2007.

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[3] FTB's adjustments for 2007 differed from the final federal determination in one respect: FTB did not impose an accuracy-related penalty for 2007.

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DISCUSSION

R&TC section 18622(a) provides that if the IRS makes a change or correction to any income, deduction, penalty or credit amount required to be shown on a taxpayer's federal tax return, the taxpayer must report the change to FTB "and shall concede the accuracy of the [federal] determination or state wherein it is erroneous." A state tax determination based on a final federal adjustment is presumptively correct and the taxpayer bears the burden of proving it erroneous. (*Appeal of Brockett* (86-SBE-109) 1986 WL 22731; *Appeal of Magidow* (82-SBE-274) 1982 WL 11930.) In addition, deductions are a matter of legislative grace, and a taxpayer claiming a deduction has the burden of proving by competent evidence that he or she is entitled to it. (See *New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435; *Appeal of Myers* (2001- SBE- 001) 2001 WL 37126924.) Unsupported assertions generally will not satisfy a taxpayer's burden of proof. (*Appeal of Magidow, supra*; *Appeal of Seltzer* (80-SBE-154) 1980 WL 5068.)

For appellants' expenses to be deductible, appellants must substantiate the expenditures, establish that they are deductible under either IRC section 162, 167, or 212, and show that the deductions are not prohibited by IRC section 262.[4] IRC section 162 allows taxpayers to deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." IRC section 167 allows "depreciation deductions" for the exhaustion, wear and tear of (1) property used in a "trade or business," or (2) property "held for the production of income." As pertinent here, IRC section 212 allows individual taxpayers to deduct ordinary and necessary expenses paid or incurred during the taxable year "for the management, conservation, or maintenance of property held for the production of income." Finally, IRC section 262 is a deduction-override provision; it prohibits taxpayers from deducting their "personal, living, or family expenses."

We conclude, consistent with the IRS's determination, that appellants' claimed expenses are not deductible under IRC section 162 because appellants have not shown that the expenses were paid in connection with a bona fide "trade or business." The definition of "trade or business" is not found in the IRC, but the U.S. Supreme Court has provided us with a well-known rule of thumb: to be engaged in a trade or business, a taxpayer must (1) be involved in

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[4] California conforms to these provisions pursuant to R&TC section 17024.5(a)(1)(N).

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the activity with continuity and regularity, (2) the primary purpose of which is income or profit. (*Commissioner v. Groetzinger* (1987) 480 U.S. 23, 35.) Although appellants were doing construction work and improvements on their 20-acre property, they have not proven that the work done on the property was in connection with a bona fide trade or business the primary purpose of which was income or profit during the years at issue. In this regard, we note that appellants did not report receiving any rental (or other) receipts from their alleged business in either year.[5] In fact, they have provided no documentary evidence showing that they even attempted to rent their guest house during these years.[6]

Wolfgram v. Commissioner, T.C. Memo. 2010-69, 2010 WL 1379711 (*Wolfgram*) is instructive here. In *Wolfgram*, the taxpayer claimed to have been in the "trade or business" of setting up and operating a bed-and-breakfast inn during 2004 and 2005. The taxpayer and her husband bought a picturesque piece of land in Michigan Bluff, California, and began construction of a home on the property. While constructing the home (which, upon completion in 2007, became the taxpayer's residence) the taxpayer's husband lived in a rented mobile home that was parked on the property. The taxpayer deducted, in 2004 and 2005, various expenses incurred in connection with the construction of the home (contract labor, truck mileage, rental expense for the mobile home, and utilities). The IRS disallowed the deductions. The taxpayer appealed to the U.S. Tax Court, which upheld the IRS disallowances. The court found that the taxpayer had not satisfied the "threshold requirement" of establishing that her activities constituted a bona fide trade or business, stating as follows:

> In considering whether the Wolfgrams' involvement with the alleged bed-and-breakfast inn was sufficiently continuous and regular, it does not matter whether the Wolfgrams intended to sell the house or operate it as a bed-and-breakfast inn. If they intended to operate it as a bed-and-breakfast inn, no such operation ever began because the Wolfgrams never had a customer. Nor is there any evidence of any sales efforts that could have led to customers. If the Wolfgrams intended to sell the house, the construction and sale of a single bed-and-breakfast inn did not constitute continuous and regular activity; it was a "one-time job". They did not provide evidence that they ever attempted to sell the new house to a bed-and-breakfast operator. Thus, they were not carrying on a trade or business during the

[5] Appellants have provided us with excerpts from their Schedule C's for more recent years, 2011 through 2016, on which they reported gross rents from a rental activity. However, those Schedule C's identify the property being rented as Unit A, whereas the property allegedly held out for rent in 2006 and 2007 was Unit B.

[6] In light of this, appellants' attempt to blame their inability to find tenants for the property on the government, the banks, and the Great Recession is unavailing.

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> years at issue because they did not show they were engaged in an activity with regularity and continuity. [Citations omitted.]

(*Wolfgram*, *supra*, 2010 WL 1379711 at p. *7.) As in *Wolfgram*, in the case before us, appellants did not have any customers for their "business" during the years at issue, or show that they undertook efforts to acquire customers. Accordingly, they have not satisfied their burden of proving that they were carrying on a bona fide trade or business during the years at issue.

Appellants also are not entitled to the depreciation deductions they claimed with respect to their Schedule C businesses. Depreciation deductions are allowed with respect to property that is either "used in the trade or business" or "held for the production of income." (IRC, § 167(a).) Because, as we conclude above, appellants were not engaged in a bona fide trade or business during the years at issue, their depreciation deductions are not allowed under IRC section 167(a)(1). For depreciation to be allowed under IRC section 167(a)(2), appellants must establish that their guest house was property that was "held for the production of income" during the years at issue. This is "an annual determination." (*McKinney v. Commissioner*, T.C. Memo. 1981-181). Here, appellants have not shown any attempt to produce income from the property during the years at issue; hence, they are not entitled to depreciation deductions under IRC section 167(a)(2). (See *Robinson v. Commissioner*, T.C. Memo. 2014-120, 2014 WL 2719658 at p. *6 ["a serious lack of effort to rent or sell . . . indicates that the property was not held for the production of income"]; *Meredith v. Commissioner* (1975) 65 T.C. 34, 42 [deductions disallowed because property not held for the production of income during the years at issue, finding that "although the rental market [for the property] in the Pebble Beach area was minimal, petitioner took less than minimal steps to rent the property"].)

Appellants produced numerous utility and purchase receipts reflecting activity on the 20-acre parcel, which contains both their personal residence and their guest house. Noticeably absent from that documentation is any evidence that the guest house was held out for rent (e.g., advertisements for rent, rent receipts, rental applications, rental agreements). Thus, we find appellants have not sustained their burden of proving that they held the guest house property for the production of income during the years at issue.[7]

[7] Appellants also have not provided evidence demonstrating that the guest house was "held for production of income" in relation to a future sale. In this respect, we note that simply holding property with the intent of making a profit on an eventual future sale, by itself, generally is *not* sufficient to establish a profitmaking intent. (*Ohana v. Commissioner*, T.C. Memo. 2014-83, 2014 WL 1851903 at p. *6; *Jasionowski v. Commissioner* (1976) 66 T.C. 312, 323.)

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Our conclusion that appellants have not shown that their guest house was held for the production of income also means that appellants are not entitled to deductions under IRC section 212. As relevant here, that section permits individual taxpayers to deduct ordinary and necessary expenses paid or incurred during the taxable year "for the management, conservation, or maintenance of property *held for the production of income*." (IRC, § 212, italics added.) Accordingly, appellants have not sustained their burden of proving that FTB erred in denying their claimed deductions.[8]

HOLDING

Appellant have not satisfied their burden of proving error in FTB's proposed assessments for 2006 and 2007.

DISPOSITION

FTB's proposed assessments for 2006 and 2007 are sustained in full.

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Jeffrey I. Margolis
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Jeffrey I. Margolis
Administrative Law Judge

We concur:

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Nguyen Dang
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Nguyen Dang
Administrative Law Judge

DocuSigned by:
Kenneth Gast
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Kenneth Gast
Administrative Law Judge

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[8] Because we decide this case based on appellants' failure to prove that they were carrying on a trade or business for profit during the years at issue, we will not address the alternative bases upon which the IRS disallowed these deductions—appellants' failure to adequately substantiate their expenditures, and prove that the amounts expended were not for personal, family or living expenses. We do note, however, that appellants deducted thousands of dollars of landscaping, irrigation and construction expenses, and appellants have not shown how much, if any, of those expenses related to the main house (appellants' personal residence), the guest house, or other portions of their 20-acre property.