

BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

IN THE MATTER OF THE APPEAL OF,)
)
DON NEWTON,) OTA NO. 18011717
)
)
) APPELLANT.
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TRANSCRIPT OF PROCEEDINGS

Cerritos, California

Thursday, December 19, 2019

Reported by:
ERNALYN M. ALONZO
HEARING REPORTER

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BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

IN THE MATTER OF THE OF,)
DON NEWTON,) OTA NO. 18011717
APPELLANT.)
_____)

Transcript of Proceedings, taken at
12900 Park Plaza Dr., Cerritos, California, 91401,
commencing at 10:04 a.m. and concluding
at 10:26 a.m. on Thursday, December 19, 2019,
reported by Ernalyn M. Alonzo, Hearing Reporter,
in and for the State of California.

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APPEARANCES:

Panel Lead: ALJ SARA HOSEY

Panel Members: ALJ JOHN JOHNSON
ALJ KENNY GAST

For the Appellant: DON NEWTON
CHRISTOPHER ENGELMANN

For the Respondent: STATE OF CALIFORNIA
FRANCHISE TAX BOARD
By: BRIAN WERKING

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1 Cerritos, California; Thursday, December 19, 2019

2 10:04 a.m.

3

4 JUDGE HOSEY: We are now on the record.

5 This is the appeal of Don Newton, Case
6 Number 18011717. Today is December 19th, 2019. It's
7 approximately 10:04 a.m. We're in Cerritos, California.
8 I am lead Administrative Law Judge Sarah Hosey. With me
9 today are Judges John Johnson and Kenny Gast.

10 Parties can I have you state your names for the
11 record, please.

12 MR. WERKING: Brian Werking, Franchise Tax Board.

13 MR. ENGELMANN: Chris Engelmann, taxpayer
14 representative.

15 MR. NEWTON: Don Newton.

16 JUDGE HOSEY: Thank you. Our issue today is:
17 Whether Appellant has demonstrated error in FTB's proposed
18 assessment, which is based on federal adjustments.

19 Mr. Engelmann, is that correct?

20 MR. ENGELMANN: Yes, that is correct.

21 JUDGE HOSEY: Mr. Werking?

22 MR. WERKING: Yes, that's correct.

23 JUDGE HOSEY: Thank you. We marked Exhibits 1
24 through 8 for Appellants and A through K for Respondent,
25 FTB, at the prehearing conference held on

1 December 3rd, 2019. No objections were made, and these
2 were admitted as evidence into the record for the
3 prehearing conference minutes and orders on
4 December 4th, 2019. No additional exhibits have been
5 presented today.

6 Mr. Engelmann, is this accurate?

7 MR. ENGELMANN: Yes, that's accurate.

8 JUDGE HOSEY: And Mr. Werking?

9 MR. WERKING: Yes, this is.

10 JUDGE HOSEY: Okay. Mr. Engelmann, are you ready
11 to begin your opening?

12 MR. ENGELMANN: Yes, I am.

13 JUDGE HOSEY: Please begin.

14

15 OPENING STATEMENT

16 MR. ENGELMANN: So as you stated, the issue is
17 whether Appellant has demonstrated error in FTB's proposed
18 assessment, which is based on federal adjustment. For
19 years Mr. Newton owns and has operated a local wholesale
20 car business as a sole proprietorship. And he makes his
21 entire income through his business. He does this by
22 buying used cars and later on selling those cars for a
23 profit and solely that.

24 The issue here is in 2010 when he generated
25 \$92,687 in gross receipts. Upon receipt, the IRS audited

1 Mr. Newton's 2010 return. FTB then assessed the
2 additional tax and issued a Notice of Proposed Assessment
3 with additional tax \$4,219 and an accuracy-related penalty
4 of \$843.80, which was dated on September 11, 2015.

5 Mr. Newton then timely proposed the NPA. And
6 additionally, to that in November 2015, the IRS lien was
7 released. On April 3, 2017, FTB issued and NOA affirming
8 the proposed \$4,219 tax assessment along with the
9 accuracy-related penalty, which later admitted by FTB that
10 actually Appellant, he was erroneously proposed and,
11 therefore, abated.

12 In response, Mr. Newton filed a timely appeal to
13 the BOA. Further exchanges of the briefs, the Cohan Rule
14 has been mentioned numerous times, and how it's applied
15 now remains in debate. Per the Cohan Rule, which arose by
16 the US Court of Appeals for the Second Circuit, Cohan v.
17 Commissioner, states when it is apparent that some
18 business expense or deduction should be allowed but
19 available records are inadequate to accurately determine
20 the amount of the allowable deduction, the Court may order
21 a reasonable estimate of the amount.

22 The BOE has mentioned -- has filed the Cohan Rule
23 in its decisions. For example, the Pacific Coast Building
24 where they decided that because the taxpayer did qualified
25 research that they would apply, the Cohan Rule. And then,

1 again, you see this in Doug Kinnen -- in Duncan, when they
2 concluded that, even though they -- there wasn't a way to
3 determine the amount, they allowed additional time for the
4 taxpayer to get an additional amount.

5 And then per the FTB's brief, Mr. Newton has not
6 created a foundation upon which an estimate may be made
7 and relies heavy on Vanicek v. Commissioner, which states
8 that the Cohan Rule cannot be applied because the
9 foundation to estimate cost were not made. The FTB states
10 that provided invoices showing \$92,686 in gross receipts
11 does not create a foundation for any kind of estimate and
12 can be made in which the Cohan Rule can apply.

13 How are the facts in that case versus ours
14 differs? In that case, the taxpayer was in charge of
15 safe-guarding property and while they were safe-guarding
16 property, they were assigned to live on that property.
17 And though while they were living there, they wanted to
18 deduct their utilities. And the Court said it was fine,
19 that they can deduct their utilities. But the problem was
20 whether there was a way to determine, out of those
21 utilities, whether there -- which ones were ordinary
22 business expenses versus their own personal uses.

23 Here in this case, we don't have that issue at
24 all. Mr. Newton's entire inventory was solely based for
25 ordinary and necessary expenses. In addition to that, you

1 know, he -- in addition to that, his gross inventory, he
2 cannot operate his business without that inventory. So we
3 have the combination of the necessity of his inventory to
4 have his business operate, combined with that, can kind of
5 create a foundation for that.

6 In addition, he has provided evidence showing
7 that there was a fire. And so as far as, like, precise
8 and accurate, you know, estimations cannot be possible.
9 And then also he has also showed, like, research to find
10 as many invoices that he possibly can. And, therefore,
11 the Cohan Rule should apply because we have the
12 combination of the necessity of his business needing to
13 operate because of those cost and goods sold. We also
14 have the -- the attempt as well as, like, the foundation
15 to have the Cohan Rule apply. And, therefore, he should
16 have those cost and goods deducted.

17 Thank you.

18 JUDGE HOSEY: Thank you.

19 Mr. Newton, we're going to swear you in for your
20 testimony. Can you please stand and raise your right
21 hand.

22 MR. NEWTON: Yes.

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DON NEWTON,

produced as a witness, and having been first duly sworn by the Administrative Law Judge, was examined and testified as follows:

JUDGE HOSEY: Thank you. Please have a seat. Go ahead and begin. You're free to have Mr. Engelmann ask you questions, or you can just tell us your story, kind of, what happened.

WITNESS TESTIMONY

MR. NEWTON: Okay. Basically, it's like he said.

STENOGRAPHER: I'm sorry. Can I have you speak please, speak up.

MR. NEWTON: Yes. I'm sorry. This happened back in 2010. And if you look at the income taxes before that and after that, I've always had the deductions of applying the cars and then turning around and selling them. For some reason, they didn't allow me the -- from paying for the cars, and I don't know how that was.

JUDGE HOSEY: Can you explain to us a little bit more about your business? How it runs.

MR. NEWTON: Yeah. I go to some of the dealerships and some of the trade-in cars that have the high miles. So they would go ahead and sell those to me

1 because I have a wholesale dealer's license with the DMV.
2 And with those cars, I would either take them to wrecking
3 yards or another auction and sell them. And then with
4 that difference is the profit.

5 JUDGE HOSEY: Okay. We understand. Do you have
6 any questions for Mr. Newton?

7

8

DIRECT EXAMINATION

9 BY MR. ENGELMANN:

10 Q How do you determine the amount of your
11 deductions?

12 A What I paid for the car and what the car sold for
13 and then if I had to do anything with the car; and then
14 that's where I would get that. And then I would get an
15 alternate tax deduction at the end of the year. And
16 that -- that's how they would come up with the income tax.

17 Q So is it just an estimation or is it an exact
18 figure?

19 A In between the filing for the income for the
20 year, when I do the cars, we do folders for each car. And
21 it has the check of what we paid for and a check for what
22 we sold it for. And then if I had to do something with
23 it, we would put the receipts inside there.

24 Q And then does your business make any income
25 besides that?

1 A No. And then in 2010 when this happened, it was
2 a very, very bad year. This is the year the house went
3 into foreclosure, and there was a fire at the place I
4 rented. It was like a little strip mall, and the place
5 burnt down. And I wasn't the only office there. There
6 was 73 offices. And my office was the size of a bathroom,
7 but it qualified for the DMV because the rent was only
8 one-hundred and something dollars a month to have a
9 dealer's license and the filing cabinet in there.

10 Q Did you have a percentage markup?

11 A I would say between 10 and 20 percent.

12 MR. ENGELMANN: I have no further questions.

13 JUDGE HOSEY: Okay. Great. Thank you.

14 Mr. Werking, do you have any questions?

15 MR. WERKING: No questions from FTB.

16 JUDGE HOSEY: Okay. And I'll go to my panel
17 members. Mr. Johnson?

18 JUDGE JOHNSON: No questions.

19 JUDGE GAST: No questions.

20 JUDGE HOSEY: Okay. All right. Mr. Engelmann
21 are you ready for your closing statements?

22 MR. ENGELMANN: Sure.

23 JUDGE HOSEY: Please begin.

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CLOSING STATEMENT

MR. ENGELMANN: So, I mean, everyone here agrees that the cars -- he sold these cars to make a profit. And I mean, we've kind of agreed that there's a gross invoice -- income. We also agree that he can't make that money without even buying the used cars and then selling it for a profit. So -- and we also have him under testimony showing a way to, kind of, give a figure on what that amount could be.

And because we have that, combined with what I previously said as far as the necessity to have the continued business to buy that inventory for the business to continue, as well as the Cohan Rule that says you do not need an exact amount or any deductions to take place, you just need a foundation. We have that foundation here. And we also have a figure that we can have. Therefore, the Cohan Rule should apply and the deduction should be granted.

JUDGE HOSEY: Okay. Thank you. Mr. Werking, are you ready to begin your closing?

MR. WERKING: Yes.

JUDGE HOSEY: Please begin.

CLOSING STATEMENT

MR. WERKING: The issue in this case is whether

1 Appellant has shown error in Respondent Franchise Tax
2 Board's proposed assessment, which is based on a federal
3 adjustment. Appellant has not established error in the
4 proposed assessment.

5 The IRS made adjustments to Appellant's 2010 tax
6 year account disallowing Appellant's cost of goods sold.
7 California law conforms to federal law regarding
8 deductions for cost of goods sold. Following federal
9 adjustment, Respondent proposed to disallow Appellant's
10 reported cost of goods sold and proposed a deficiency
11 assessment as well as settle that proposed deficiency
12 assessment by Respondent that is based on a federal
13 adjustment is presumptively correct, and the Appellant
14 bears the burden of proving it erroneous.

15 Appellant cannot substantiate his claims cost of
16 goods sold, but argues that under the Cohan Rule, he's
17 entitled to deduct some estimation of his cost of goods
18 sold. Although, the tax payer bears the burden to prove
19 that the Internal Revenue Service adjustments or that
20 FTB's proposed assessment based on federal adjustment is
21 erroneous. In certain circumstances it may be appropriate
22 to allow an estimated amount for a deductible expense.

23 There is no automatic right to an estimate of an
24 expense deduction under the Cohan Rule. The Board of
25 Equalization, OTA's predecessor, has indicated its

1 reluctance to disturb Respondent's determination involving
2 unsubstantiated amounts without independent fact on which
3 to base a different finding.

4 In order to estimate the amount of an expense,
5 the courts have held that there must be a sufficient
6 foundation upon which an estimate may be made. Appellant
7 has not submitted sufficient independent evidence on which
8 an estimate of Appellant's cost of goods sold could be
9 computed under the Cohan Rule.

10 Instead, Appellant has provided a copy of a
11 single sales contract that does not include any
12 information pertaining to Appellant's cost of the cars
13 sold. And has submitted evidence of various car purchases
14 made in the 2010 tax year without any information
15 pertaining to when those cars were sold or the price at
16 which they were sold; neither of which provide a
17 foundation to establish a method to estimate Appellant's
18 cost of goods sold.

19 The evidence provided is insufficient to
20 substantiate the cost of cars that were sold in 2010 and
21 is insufficient to establish a foundation to estimate
22 Appellant's cost of goods sold. Accordingly, Respondent
23 respectfully request the OTA to affirm Respondent's
24 proposed deficiency assessment.

25 Thank you.

1 JUDGE HOSEY: Okay. Thank you. Do we have any
2 questions from the judges?

3 JUDGE JOHNSON: Yes, just one question. When
4 looking at the Cohan Rule and, you know, the need to
5 provide some kind of evidence to support a basis for an
6 alternate finding, what role does the fact that documents
7 that could have been available have been lost, play in
8 that? And do you have some sort of evidence to show that
9 there is a lost? Or -- I guess, what role does that play?

10 MR. WERKING: Well, in this particular case, I
11 would like to point out that -- that when the audit --
12 when the federal audit was opened, it was on
13 September 6, 2012. And at that time, Appellant should
14 still have had his records. There was no -- the
15 alleged -- or the fire occurred on February 7th of 2014.
16 That was a month and a half before the federal audit
17 closed.

18 So at that time, Appellant should have had any
19 records available. I mean, the fire -- any fire would not
20 have hampered that effort. As far as taking into account
21 the lack of records or the difficulty in obtaining the
22 records, that does not factor in how one would lay a
23 foundation to create an estimate. And that's what's
24 really lacking here.

25 Respondent does appreciate that records may have

1 been lost and would not be able -- that the records of the
2 actual expenses may not be able to be provided. But there
3 are alternative items of evidence that could possibly been
4 obtained, but we just don't have that foundation to tie
5 the cost of any car sold to be able to even begin to make
6 an estimation.

7 JUDGE JOHNSON: Thank you.

8 JUDGE HOSEY: Judge Gast.

9 JUDGE GAST: Yeah, just one or two questions. So
10 no COGS were allowed for Appellant; is that correct?

11 MR. WERKING: That's correct.

12 JUDGE GAST: Okay. So kind of going with what
13 Judge Johnson said. You know, he clearly operated a
14 business. So wouldn't he have had cost of goods sold?
15 And if so, is there any way to estimate that even though
16 he doesn't have the business records?

17 MR. WERKING: I -- I could not come up with --
18 Respondent could not come up with, you know, a method
19 to -- to make an estimation in this case. Appellant could
20 have possibly obtained insurance records to show, you
21 know, the change in the inventory that -- or over the year
22 in which taxpayer may have insured his inventory to show
23 that a fluctuation would show, or perhaps the cost of
24 goods sold. I -- but just with the information that was
25 available and presented, there is -- I wouldn't even know

1 where to begin to come up with an estimation.

2 JUDGE GAST: Okay. Thank you.

3 JUDGE HOSEY: Any other questions?

4 JUDGE GAST: No further questions.

5 JUDGE HOSEY: Okay. Mr. Engelmann, would you
6 like to make a final statement, a rebuttal to Mr. Werking
7 or to any questions the judges had?

8 MR. ENGELMANN: Yes.

9 JUDGE HOSEY: Go ahead.

10

11

REBUTTAL STATEMENT

12 MR. ENGELMANN: So as far as, like, creating A
13 foundation, we have given -- Mr. Newton has provided under
14 oath that there is a way that we can get an estimate as
15 far as by that percentage markup or things of that nature.
16 We, you know, we've also like -- and like I've said.

17 I want to regurgitate. He can't have his
18 business continue without any -- any cost of goods
19 deducted. So to have it where he has no cost of goods
20 deducted, would be erroneous and just would not make sense
21 at all.

22 Thank you.

23 JUDGE HOSEY: Okay. Thank you. So we have your
24 evidence and the testimony provided today. Is there
25 anything else you prepared, or anything else you would

1 like to tell us before I submit the case?

2 MR. NEWTON: Yes.

3 JUDGE HOSEY: Yes, Mr. Newton.

4 MR. NEWTON: When all this happened, and I got
5 the audit from the IRS, that lady that did the audit, when
6 I went down there, she extended it out because they were
7 moving the IRS office to Downtown San Diego. And they
8 moved it out a whole six months. And like I said, all
9 those records were inside that filing cabinet. And I
10 provided copies of the fire report. And I did go back to
11 the auction, and I tried to pull the invoices from them.
12 And I gave them the letter showing that their books don't
13 go back that far.

14 I don't use a computer. Back then I even used a
15 flip phone because a phone is a phone. To me it's not a
16 computer. Everything was in writing. It was very simple.
17 It was, you know, you buy the car for this. There's a
18 check, and you sell the car for this. It's a business.

19 If you look at the income taxes before that and
20 after that, and the same lady I used, that's the way she
21 did it. And she didn't even keep copies of it. And I did
22 send some of those to the IRS and the Franchise Tax Board.
23 I was able to pull three or four invoices from the
24 auction, and they were there.

25 JUDGE HOSEY: I'm just looking at our exhibits.

1 MR. NEWTON: Ma'am, there was one more thing too.

2 JUDGE HOSEY: Yes, please.

3 MR. NEWTON: I was questioned -- I don' know if
4 it was through the IRS or if it was the Franchise Tax
5 Board. On one of the briefs I read, it said -- about the
6 fire happening -- it said that the building was condemned,
7 and that wasn't true because I gave them the letter that
8 it was a strip mall and it was two parcels.

9 So they started doing construction on one parcel
10 to put the apartment complex in. My parcel was still good
11 for another eight months, and I had a lease there because
12 it was brought up in one of the papers. I don't know if
13 it was through the Franchise Tax Board or the IRS. So I
14 had the owner of the complex write a letter saying, no, he
15 was there at the time of the fire, and he had a lease for
16 eight more months.

17 JUDGE HOSEY: Is there anything else you would
18 like to add or say?

19 MR. NEWTON: You know, if I would have made the
20 money, I would have paid it. You know, I took my stuff
21 down. Basically, like I said, you know, it's a check.
22 It's a check. That's receipts. It happened.

23 JUDGE HOSEY: Thank you. I appreciate your time.
24 We're ready to submit the case. The record is now closed.
25 This concludes the hearing. And the judges will meet and

1 decide the case based on the documents and arguments
2 presented today. We will aim to send both parties our
3 written decision no later than 100 days from today.

4 The hearing is now in recess in preparation for
5 the next case. Thank you.

6 (Proceedings adjourned at 10:26 a.m.)

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HEARING REPORTER'S CERTIFICATE

I, Ernalyne M. Alonzo, Hearing Reporter in and for the State of California, do hereby certify:

That the foregoing transcript of proceedings was taken before me at the time and place set forth, that the testimony and proceedings were reported stenographically by me and later transcribed by computer-aided transcription under my direction and supervision, that the foregoing is a true record of the testimony and proceedings taken at that time.

I further certify that I am in no way interested in the outcome of said action.

I have hereunto subscribed my name this 21st day of January, 202.

ERNALYN M. ALONZO
HEARING REPORTER