OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18032402
BLAIR S. BINDLEY	) Date Issued: May 30, 2019

OPINION

Representing the Parties:

For Appellant: Timothy J. DuVall, CPA

For Respondent: Mira Patel, Tax Counsel

For Office of Tax Appeals: Andrea Long, Tax Counsel

P. KUSIAK, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, Blair S. Bindley (appellant) appeals an action by respondent Franchise Tax Board (FTB) affirming its proposed assessment of $532 additional tax, a $135 late-filing penalty, and applicable interest, for the 2015 tax year.

Appellant waived his right to an oral hearing; therefore, the matter is being decided based on the written record.

ISSUE

Whether appellant had taxable income from a California source in 2015.

FACTUAL FINDINGS

1. Appellant is a self-employed screenplay writer providing services to companies producing films and television shows. On or around September 1, 2014, appellant contracted with Mindbender Enterprises, LLC (Mindbender), a motion picture producer, for appellant's writing services to write a screenplay. The contract specifies that appellant's work would be considered "work-for-hire" and Mindbender would therefore be considered the author and copyright owner of appellant's screenplay. On or around December 18, 2015, appellant similarly contracted with Lakeshow Films, LLC

(Lakeshow) to write an original screenplay for the producer. The contract specifies that the screenplay would be considered a "work-made-for-hire" for Lakeshow. Both Mindbender and Lakeshow (collectively, "LLCs") were headquartered and registered in California.

2. FTB annually matches income records obtained from various reporting sources against filed returns to identify individuals who may have not fulfilled their legal requirement to file a California tax return. FTB received information that during 2015, appellant received $25,000 of income from Mindbender and $15,000 of income from Lakeshow. FTB sent appellant a Request for Tax Return (Request) dated May 11, 2017, stating that it had no record of receiving appellant's 2015 return. The Request required appellant to file a 2015 return or explain why he was not required to file a 2015 return. Appellant's response was due by June 14, 2017.

3. FTB received appellant's reply on July 6, 2017. Appellant explained that he did not have California-source income, because he performed all services for Mindbender and Lakeshow in Arizona. During the 2015 tax year, appellant was an Arizona resident.

4. FTB rejected appellant's explanation, because appellant had performed services for California LLCs, and thus, had California-source income. On July 10, 2017, FTB sent appellant a Notice of Proposed Assessment (NPA). The NPA reflected an estimated income of $31,377,[1] deductions of $4,044,[2] and taxable income of $27,333. Based on this estimate, the NPA proposed a total tax liability of $532 based on the standard deduction and exemption credits for a single individual with no dependents.[3] The NPA imposed a late-filing penalty of $135, plus interest.[4]

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[1] Appellant also received a schedule K-1 from Rockpoint Gas Storage LLC, a California LLC, that reported a loss of $8,623. FTB thus reduced appellant's estimated income by that amount.

[2] FTB applied the standard deduction for a single individual with no dependents. For the 2015 tax year, a single individual under age 65 with no dependents realizing a California gross income of $16,256 or a California adjusted gross income of $13,005 was required to file a California income tax return.

[3] The NPA indicated the amounts assessed would be revised for any differences in filing status, additional deductions, exemptions, or credits when the required tax return was filed. Appellant provided information to indicate a filing status of married filing jointly status and more than two dependents. Residents of some states, including Arizona, may receive a credit (Other State Tax Credit) for taxes paid to the state of residence on income subject to tax in California. However, because appellant never filed a California return for the year at issue, the NPA was not revised.

[4] Since appellant did not challenge the late-filing penalty, other than asserting no tax was due, we are not discussing the penalty.

5. Appellant's federal income tax transcript for 2015 indicated appellant filed a federal return as married filing jointly and that appellant had self-employment income of $99,160.

6. Appellant timely protested the NPA by a letter dated August 2, 2017. Following protest proceedings, FTB issued a Notice of Action dated October 5, 2017, affirming the NPA. Appellant filed this timely appeal.

DISCUSSION

R&TC section 18501 requires every individual subject to the Personal Income Tax Law to make and file a return with the FTB "stating specifically the items of the individual's gross income from all sources and the deductions and credits allowable," in excess of certain filing thresholds. (R&TC, § 18501(a)(1)-(4).) 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."

California imposes a tax on the entire taxable income of a nonresident, such as appellant, to the extent it is derived from sources within this state. (R&TC, §§ 17041(b), 17951(a).) When the FTB makes a proposed assessment of additional tax based on an estimate of income, the FTB's initial burden is to show why its proposed assessment is reasonable and rational. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Myers* (2001-SBE-001) 2019 WL 1187160.) An assessment based on unreported income is presumed correct when the taxing agency introduces a minimal factual foundation to support the assessment. (*In re Olshan* (9th Cir. 2004) 356 F.3d 1078, 1084 [citing *Palmer v. Internal Revenue Service* (9th Cir. 1997) 116 F.3d 1309, 1312]; *Appeal of Bailey* (92-SBE-001) 1992 WL 44503.)

Once the FTB has met its initial burden, the proposed assessment of additional tax is presumed correct and the taxpayer has the burden of proving it to be wrong. (*Todd v. McColgan*, *supra*, 89 Cal.App.2d at p. 514; *Appeal of Myers*, *supra*.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Magidow* (82-SBE-274) 1982 WL 11930.) In the absence of credible, competent, and relevant evidence showing error in the FTB's determination, the determination must be upheld. (*Appeal of Seltzer* (80-SBE-154) 1980 WL 5068.) A taxpayer's failure to produce evidence that is within his control gives rise to a presumption that such evidence is unfavorable to his case. (*Appeal of Cookston* (83-SBE-048) 1983 WL 15431.)

Here, appellant failed to file a 2015 return, even after FTB issued him a Request. As a result, FTB estimated appellant's 2015 income based on information reported on 2015 Forms 1099-MISC that were issued by California LLCs. Appellant does not dispute that he received the income reported on these two Forms 1099-MISC during 2015. FTB's use of Forms 1099-MISC to estimate appellant's taxable income is both reasonable and rational. (See *Giddio v. Commissioner* (1970) 54 T.C. 1530, 1533; *Andrews v. Commissioner*, T.C. Memo. 1998-316.) Moreover, public records from the California Secretary of State provided by FTB show that both LLCs are registered and located in California. FTB established "a minimal predicate" for its determination. (*Andrews v. Commissioner, supra*.) This evidence sufficiently links appellant with income-producing activity in California, and FTB's initial burden has therefore been met. (See *Williams v. Commissioner* (4th Cir. 1993) 999 F.2d 760, 763-766; *Rapp v. Commissioner* (9th Cir. 1985) 774 F.2d 932, 935.)

Appellant contends that he does not have a filing requirement because he was domiciled in, and was a resident of, Arizona during the tax year at issue. Although there is no dispute that Mindbender and Lakeshow were located in California, appellant argues that because he performed all the work in Arizona, his income is not taxable by California.

California Code of Regulations, title 18, section 17951-4

Taxable income of nonresidents "shall be allocated and apportioned under rules and regulations prescribed by the [FTB]." (R&TC, § 17954.) California Code of Regulations, title 18, (Regulation) section 17951-4 provides income sourcing provisions for a nonresident's trade, business, or profession. Under this regulation, the application of the apportionment rules depends upon whether the taxpayer is carrying on a trade or business within the state, without the state, or a combination thereof; the type of entity conducting that business (i.e., sole proprietorship, partnership, or subchapter S corporation); and whether the business is unitary.

1. Appellant Was Carrying on a Business Within and Without California.

As previously mentioned, California imposes a tax on the taxable income of every nonresident, provided that the nonresident meets the filing status threshold requirements of R&TC section 18501(a). (R&TC, § 17041(b)(2).) "Taxable income of a nonresident" is broadly defined as "gross income and deductions derived from sources within this state." (R&TC, § 17041(i)(1)(B).) Income from sources within this state includes "income from a business,

trade or profession carried on within this State . . . .” (Cal. Code Regs., tit. 18, § 17951-2.) Indeed, the statutory provisions make no mention that a nonresident must have a physical presence in the state for California to impose a tax.

Here, appellant received income for his services as a self-employed screenwriter from Mindbender and Lakeshow, which are both California LLCs. Appellant was a resident of Arizona where he performed his services as a self-employed screenwriter. He also received $40,000 of gross income from his services as a self-employed screenwriter from California customers. Consequently, appellant’s trade or business as a self-employed screenwriter was carried on within and without the state. We find appellant was carrying on a business within and without California.

2. Appellant Was Conducting Business as a Sole Proprietorship.

The term “sole proprietorship” is not defined in Regulation section 17951-4(c), or in the R&TC. A dictionary definition of a “sole proprietorship” is “[a] business in which one person owns all the assets, owes all the liabilities, and operates in his or her personal capacity.” (Black’s Law Dict. (10th ed. 2014).) For federal and California income tax purposes, a sole proprietorship neither files income tax returns nor pays income tax. Rather, the owner of the sole proprietorship reports all items of income on his or her individual tax return (i.e., on federal Schedule C) and must pay any taxes due.

Here, there is no dispute that appellant, as the owner of a sole proprietorship, was a self-employed screenwriter providing services to companies producing films and television shows. Therefore, based on the evidence before us, we find that appellant conducted his screenwriter business as a sole proprietorship during 2015.

3. Appellant Was Carrying on a Unitary Business.

Regulation section 17951-4 does not define the term “unitary business,” but the definition can be inferred from Regulation section 17951-4(b). Regulation section 17951-4(c) applies to a sole proprietorship carrying on a unitary business. Regulation section 17951-4(b) is its counterpart, applying to “a nonresident’s business, trade or profession . . . conducted partly within and partly without the state, and the part within the state is so separate and distinct from and unconnected to the part without the state such that the respective business activities are not part of a unitary business, trade or profession . . . .” A unitary business, therefore, can be defined

for purposes of Regulation section 17951-4 as a business, trade, or profession conducted both within and without the state, where the part conducted within the state and the part conducted without the state are *not* so separate and distinct from and unconnected to each other to be separate businesses, trades or professions.

The term "unitary business" has been well-established by judicial precedent by creating criteria for determining whether business activities conducted within and without the state were sufficiently interrelated or dependent upon or contributory to one another to be considered a single, or unitary, business. The California Supreme Court has set forth two alternative tests for determining whether a business is "unitary." In *Butler Bros. v. McColgan* (1941) 17 Cal.2d 664, 678, affd. (1942) 315 U.S. 501 (*Butler Bros.*), the court held that the existence of a unitary business may be established by applying the "three unities test." Under this test, unity exists where there is (1) unity of ownership; (2) unity of operation evidenced by central purchasing, management, accounting, etc.; and (3) unity of use in the centralized executive force and general system of operations. (*Ibid*.) Later, in *Edison California Stores, Inc. v. McColgan* (1947) 30 Cal.2d 472, 481 (*Edison California Stores*), the court developed an alternative test called the "contribution or dependency test" and held that a business was unitary if the operation of the business done within this state depended upon or contributed to the operation of the business outside the state. If either the three unities test or the contribution or dependency test is satisfied, the businesses are deemed unitary. (See *A.M. Castle & Co. v. Franchise Tax Bd.* (1995) 36 Cal.App.4th 1794, 1805.)

In addition, Regulation section 25120(b) provides, in pertinent part, that "[i]n general, the activities of the taxpayer will be considered a single business if there is evidence to indicate that the segments under consideration are integrated with, dependent upon or contribute to each other and the operations of the taxpayer as a whole." In short, while these authorities were established in the context of corporations, the essence of what constitutes a unitary business—i.e., sufficiently interrelated and dependent in-state and out-of-state business activities that render it appropriate for the income and losses to be combined and taxed as one unit—is equally applicable to sole proprietorships. (See, e.g., *Appeal of Johnson* (81-SBE-093) 1981 WL 11819 [applying the former version of Regulation section 17951-4(b) to tax income earned by a unitary business conducted through a sole proprietorship].)

Here, appellant wrote a screenplay for each of the LLCs. Appellant rendered these services to the LLCs in his capacity as an owner of a sole proprietorship. He, thus, conducted a one-service business, which only he controlled and managed. There is no indication that would call into question the conclusion that appellant's services were but one interrelated and interdependent business employing and consuming the same resources. Therefore, under *Butler Bros.*, *Edison California Stores*, and Regulation sections 25120(b) and 17951-4, we find that appellant was conducting a unitary business.

Having determined that appellant conducted a sole proprietorship within and without California, we find that appellant falls under the apportionment rules of Regulation section 17951-4(c). This regulation 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 Uniform Division of Income for Tax Purposes Act [(UDITPA)], [s]ections 25120 to 25139, inclusive, R&TC, and the regulations thereunder . . . ." (Cal. Code Regs., tit. 18, § 17951-4(c)(2).) Thus, we next address whether any of appellant's income as a self-employed screenwriter for Mindbender and Lakeshow must be apportioned to California.

California's Market-Based Sales Factor Sourcing Provisions

A taxpayer such as appellant who has income from business activity that is taxable both within and without the state must apportion business income according to the UDITPA. (R&TC, § 25121; see also Cal. Code Regs., tit. 18, § 25121.) "Notwithstanding [R&TC] section 38006, for taxable years beginning on or after January 1, 2013, all business income of an apportioning trade or business, other than an apportioning trade or business described in subdivision (b) of [R&TC] section 25128, shall be apportioned to this state by multiplying the business income by the 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 tax year and the denominator is the taxpayer's total sales everywhere during the tax year. (R&TC, § 25134; see also Cal. Code Regs., tit. 18, § 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.[5] R&TC section 25136(a)(1) provides that "[s]ales

[5] Both contracts with Mindbender and Lakeshow specifically state they are "work-for-hire" or "work made for hire" contracts. In these types of contracts, the person for whom the work was prepared is considered the author

from services are in [California] to the extent the purchaser of the service received the benefit of the services in [California]." Under the statutory grant of authority of R&TC section 25136(b), the FTB promulgated Regulation 25136-2, which provides detailed market-based sales factor sourcing provisions that implement and interpret R&TC section 25136.

Regulation 25136-2(c) states that "[s]ales from services are assigned to [California] to the extent the customer of the taxpayer receives the benefit of the service in [California]." The term, "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." (Cal. Code Regs., tit. 18, § 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[s] [i.e., Mindbender and Lakeshow] 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.
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> (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.
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> (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.
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> (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.

Here, we are unable to apply the first cascading rule under subparagraph (A). The contract does not specify the location where Mindbender or Lakeshow received the benefit, and, for purposes

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of the work "and, unless the parties have expressly agreed otherwise in a written instrument signed by them, owns all of the rights comprised in the copyright." (17 U.S.C. § 201(b).) Therefore, appellant was engaged in a sale of his writing services and not a sale of intangible property (i.e., intellectual property).

of subparagraph (A), Mindbender's and Lakeshow's billing address is irrelevant. Under subparagraph (B), we can reasonably approximate the location where the LLCs received the benefit of appellant's services. "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 [the LLCs] to the extent such information is available to [appellant]." (Cal. Code Regs., tit. 18, § 25136-2(b)(7).)

Public records from the California Secretary of State provided by FTB show that both Mindbender and Lakeshow are registered and located in California. Moreover, appellant's contracts with Mindbender and Lakeshow both list California addresses. Appellant also concedes that Mindbender and Lakeshow are California LLCs. Based on the evidence in the appeal record, we find that it was both reasonable and rational for FTB to conclude that both LLCs received the benefit of appellant's services within California. Because we have determined that the LLCs received the benefit of appellant's services in California under Regulation section 25136-2(c)(2)(B), there is no need to discuss the remaining cascading rules.

In sum, pursuant to the provisions of the UDITPA relating to the sale of services and the regulations thereunder, appellant's physical presence does not determine whether he had income derived from California, but rather it is determined by where the benefits of appellant's services were received. Having established that income from Mindbender and the income from Lakeshow are sourced to California, FTB estimated appellant's income as $31,377, based upon income appellant received from Mindbender and Lakeshow. Therefore, we find that FTB met its initial burden of showing that the proposed assessment for the 2015 tax year is reasonable and rational and that appellant did not meet his burden of proving that the proposed assessment, which is presumed correct, is erroneous.

HOLDING

Appellant received taxable income from a California source in 2015.

DISPOSITION

FTB's proposed assessment is sustained.

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Patrick J. Kusiak
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Patrick J. Kusiak
Administrative Law Judge

We concur:

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Jeffrey Margolis
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Jeffrey I. Margolis
Administrative Law Judge

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