OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18010878
ROBERT P. MCGANN	)
	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant: Robert P. McGann

For Respondent: Natasha S. Page, Tax Counsel IV

For Office of Tax Appeals: Linda Frenklak, Tax Counsel IV

M. GEARY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, appellant Robert McGann appeals an action by respondent Franchise Tax Board (FTB) proposing $619 of additional tax, a late-filing penalty of $154.75, and applicable interest, for the 2014 taxable year.

We decide the matter based on the written record because appellant waived his right to an oral hearing.

ISSUE

Was appellant required to file a California nonresident income tax return for the 2014 taxable year, and pay any taxes that were due?

FACTUAL FINDINGS

1. During the tax year at issue, appellant was a resident of Texas who did not file a 2014 California nonresident income tax return.
2. AmericaOne Financial and Insurance[1] (AmericaOne) issued appellant a 2014 Form 1099-MISC (Form 1099) from an address in California. The Form 1099 reported income of

[1] This is the name that appears on the 1099-K issued to appellant.

$33,242, which amount, if sourced to California, was sufficient to require appellant to file a 2014 California nonresident income tax return.

3. FTB sent appellant a Request for Tax Return (Request) dated July 26, 2016, telling appellant to respond by August 31, 2016, by providing a copy of his 2014 California return (if he filed one), filing a 2014 return, or explaining why he was not required to file a 2014 return.

4. On September 12, 2016, FTB received appellant's response to the Request, which indicated he was not required to file a 2014 California return because he lived and worked in Texas.

5. FTB issued to appellant a Notice of Proposed Assessment (NPA) dated December 9, 2016. The NPA proposed a tax liability of $619 based on an estimated taxable income of $33,242 and imposed a late-filing penalty of $154.75, plus interest.[2]

6. In a letter dated December 12, 2016, appellant protested the NPA, again indicating that he was not required to file a 2014 California return because he lived and worked in Texas and had never lived in California. Appellant further stated in the letter that he worked as a consultant during 2014, and, while his "manager" lived in California, his employer was a Florida-based company.

7. FTB issued a Notice of Action dated January 26, 2017, affirming the NPA. This timely appeal followed.

DISCUSSION

California requires "every individual taxable" under the Personal Income Tax Law (PITL)[3] (commencing with R&TC section 17001) to make a return to FTB, stating specifically the items of the individual's gross income from all sources and the allowable deductions and credits, if the individual derives gross income from all sources, or adjusted gross income (AGI) from all sources, in excess of certain filing status thresholds.[4] (R&TC, § 18501, subd. (a).)

[2] Appellant has not argued that the penalty was incorrectly calculated or that it should be abated for reasonable cause. Consequently, we do not discuss the penalty further.

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

[4] It is undisputed that appellant's non-employee income from AmericaOne of $33,242 exceeds the 2014 tax year filing status threshold. However, appellant still must be an "individual *taxable*" under the PITL to be required to file a California return.

California residents are subject to tax on their entire taxable income, regardless of where that income is earned or sourced. (R&TC, § 17041, subd. (a)(1).) However, nonresidents, such as appellant, are taxed only on taxable income "derived from sources within" California, which, as relevant here, is determined under R&TC section 17951 and subsequent provisions. (R&TC, § 17041, subds. (b) & (i)(1)(B).)

R&TC section 19087, subdivision (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 makes a tax assessment based on an estimate of income, FTB's initial burden is to show that its assessment is reasonable and rational. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Myers* (2001-SBE-001) 2001 WL 37126924.) Federal courts have held that the taxing agency need only introduce some evidence linking the taxpayer with the unreported income. (*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 FTB has met its initial burden, the assessment is presumed correct and the taxpayer has the burden of proving otherwise. (*Todd v. McColgan*, *supra*; *Appeal of Myers*, *supra*.)

R&TC section 17951, subdivision (a), provides that, for purposes of computing the taxable income of a nonresident, gross income includes only that which is derived from sources within California. (See also Cal. Code Regs., tit. 18, § 17951-1(a).) R&TC section 17954 provides that gross income from sources within and without (outside of) California shall be allocated and apportioned under rules and regulations prescribed by FTB. California Code of Regulations, title 18, section (Regulation) 17951-4, implements and interprets R&TC section 17954 and deals with nonresident sourcing provisions when income is derived from a business, trade, or profession. (See also Regulation 17951-2.) As relevant here, if a nonresident's business, trade, or profession is a sole proprietorship that carries on a unitary business, trade, or profession within and outside of California, the amount of net income derived from sources within California is determined under Regulation 17951-4, subdivision (c).

Regulation 17951-4, subdivision (c), provides income sourcing provisions for when a nonresident's unitary business, trade, or profession is a sole proprietorship that conducts operations within and outside of California. Under that regulation, where a sole proprietorship conducts a unitary business within and outside of California, its income is apportioned to California under the statutory apportionment provisions (beginning at R&TC section 25120) that are applicable to corporations. Thus, the requirements for application of Regulation 17951-4, subdivision (c), are: (1) taxpayer must be a nonresident; (2) taxpayer must be conducting business as a sole proprietorship; (3) taxpayer must be carrying on a unitary business, trade or profession; and (4) taxpayer's unitary business, trade or profession must be conducted within and outside of California. (*Appeal of Bindley* (2019-OTA-179P).)

There does not appear to be any dispute that appellant was not a resident of California during 2014. He was a resident of Texas. Likewise, the uncontroverted evidence establishes that appellant conducted his business as a sole proprietor. All payments made to appellant as a non-employee were made to him directly and his various tax deductions for that taxable year, totaling $29,249, are generally indicative of self-employment as a sole proprietor. It does not appear that appellant contends otherwise. Consequently, we find that appellant was a nonresident who conducted his consulting business as a sole proprietorship during 2014. Thus, the first and second requirements for application of Regulation 17951-4, subdivision (c), have been met.

The third requirement for application of Regulation 17951-4, subdivision (c), is that appellant's business be a unitary business. For our purposes, a unitary business in a business, trade or profession conducted both within and outside of the state, where the part conducted within the state and the part conducted outside of the state are not so separate and distinct from and unconnected to each other to be deemed separate businesses, trades or professions. (*Appeal of Bindley*, *supra* (2019-OTA-179P) at pp. 5-7.) Here, the evidence shows that appellant, as the sole proprietor of his consulting business, performed consulting services for AmericaOne. Appellant has not made any argument or provided any evidence to show that the business he conducted outside of California was separate or distinct from the business he conducted here. Based on the evidence, we find that appellant was conducting a unitary business. Therefore, the final requirement has been met, and we will apply California's market-based sales factor sourcing provisions set forth in Regulation 17951-4, subdivision (c).

The final requirement is that appellant must have been conducting business within and outside of California. (*Appeal of Bindley*, *supra* (2019-OTA-179P) at pp. 4-5.) The transcript shows that appellant received income of $33,242 from AmericaOne, a California company, for services rendered as an independent contractor to or for AmericaOne. There is no evidence that supports appellant's contention that he received this income from an unidentified Florida-based company. The evidence also shows that appellant performed the consulting services while in Texas, but there is no requirement that a nonresident taxpayer have a physical presence in California. (*Id*., at p. 5.) Consequently, we conclude that appellant was carrying on his business within and outside of California. This requirement is therefore met.

Regulation 19751-4, subdivision (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 Uniform Division of Income for Tax Purposes Act (UDITPA)], [s]ections 25120 to 25139, inclusive, Revenue and Taxation Code, and the regulations thereunder[.]" Thus, Regulation 17951-4, subdivision (c)(2), treats businesses conducted through sole proprietorships the same as businesses conducted through corporations or other business entities subject to the UDITPA.

Multistate taxpayers engaged in a unitary business must apportion business income according to the UDITPA. (R&TC, § 25121; see also Regulation 25121.) With certain exceptions not relevant here, for taxable years beginning on or after January 1, 2013, all business income of an apportioning business must 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 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, from services that 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, subdivision (b), FTB promulgated Regulation 25136-2, which provides detailed, market-based sales factor sourcing provisions that implement and interpret R&TC section 25136.

Consistent with the statute, Regulation 25136-2, subdivision (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 phrase, "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, subd. (b)(1).) Regulation 25136-2, subdivision (c)(2), provides that, where a corporation or other business entity is the taxpayer's customer, such as in this appeal, receipt of the benefit of the service shall be determined under the following cascading rules. First, the location of the benefit of the service is rebuttably presumed to be received in California to the extent the contract between the taxpayer and the taxpayer's customer, 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 customer receives the benefit of the service in California.[5] (Regulation 25136-2, subd. (c)(2)(A).) If the location where the benefit of the service is received cannot be determined pursuant to the preceding rule, the location(s) where the benefit is received shall be reasonably approximated.[6] (Regulation 25136-2, subd. (c)(2)(B).) If neither of the first two methods are determinative, the location where the benefit of the service is received is presumed to be in California if the customer placed the order for the service from here. (Regulation 25136-2, subd. (c)(2)(C).) Finally, if the location where the benefit of the service is received cannot be determined using any of the above three methods, that location will be deemed to be California if the taxpayer's customer's billing address is here. (Regulation 25136-2, subd. (c)(2)(D).)

The evidence does not include a copy of the contract, if any, between appellant and AmericaOne, and appellant has not produced books and records for 2014 that might aid in the sourcing determination. However, we have the transcript that indicates that the address of AmericaOne was in California when it issued the Form 1099 to appellant. This is sufficient, under Regulation 25136-2, subd. (c)(2)(B), to satisfy FTB's burden of proving that its sourcing of the income to California has a reasonable and rational basis. Therefore, it becomes appellant's burden to prove why the income was not correctly sourced to California.

[5] This presumption may be rebutted by proof that the location(s) indicated by the contract or the taxpayer's books and records was not the actual location where the benefit of the service was received.

[6] In general terms, a reasonable approximation is a determination "in a manner . . . consistent with the activities of customer based on information other than the terms of the contract and the taxpayer's books and records kept in the normal course of business." (Regulation 25136-2(b)(5).)

We have twice asked appellant to provide evidence to support his contentions. In a November 28, 2017 letter, we asked appellant to provide a copy of the AmericaOne Form 1099 and documentation to support his contention that none of his income should be sourced to California. In a March 15, 2019 letter, we asked appellant to provide information regarding the services he provided in 2014, including a copy of his agreement, if any, with AmericaOne. Both letters were sent long after FTB served its opening brief that explained why it concluded that the AmericaOne income should be sourced to California. Appellant did not respond to either letter, and he has not argued, or provided evidence to show, that AmericaOne was located outside California when appellant performed the subject services, or that his AmericaOne income has been incorrectly sourced to California. Accordingly, we find that the income that appellant received from AmericaOne during 2014 is California source income. On that basis, we also find that appellant was required to file a California nonresident income tax return for the 2014 taxable year, and pay any taxes that were due.

HOLDING

Appellant was required to file a California nonresident income tax return for the 2014 taxable year to report California source income, and pay any taxes that were due.

DISPOSITION

We sustain FTB's action.

DocuSigned by:
Michael J Geary
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Michael F. Geary
Administrative Law Judge

We concur:

DocuSigned by:
Kenneth Gast
FD75A3136CB34C2...
Kenneth Gast
Administrative Law Judge

DocuSigned by:
Sara A Hosey
6D3FE4A8CA514E7...
Sara A. Hosey
Administrative Law Judge

Date Issued: 12/30/2019