

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:

LEN A. PAUL

) OTA Case No. 18010689

) Date Issued: May 1, 2019

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OPINION

Representing the Parties:

For Appellant:

William D. Hartsock, Attorney

For Respondent:

Richard I. Tay, Tax Counsel III

For Office of Tax Appeals:

Tom Hudson, Tax Counsel III

D. BRAMHALL, Administrative Law Judge: Pursuant to California Revenue and Taxation Code section 19045,¹ Len A. Paul (appellant) appeals from the action of respondent Franchise Tax Board (FTB) in denying his protest against the proposed assessment of \$1,908.00 in additional tax and a late-filing penalty of \$477.00, plus applicable interest, for the 2003 tax year; \$24,253.00 in additional tax, an accuracy-related penalty of \$4,850.60, and a late-filing penalty of \$6,063.25, plus applicable interest, for the 2004 tax year; and \$22,475.00 in additional tax, an accuracy-related penalty of \$4,495.00, and a late-filing penalty of \$5,618.75, plus applicable interest, for the 2005 tax year.

Appellant waived his right to an oral hearing and therefore the matter is being decided on the basis of the written record.

¹ Unless otherwise indicated, all statutory references are to sections of the California Revenue and Taxation Code.

ISSUES²

1. Has appellant shown any error in FTB's proposed assessments of additional tax for the 2003, 2004, and 2005 tax years?
2. Has appellant established reasonable cause for the late filing of his tax returns for 2003, 2004, and 2005?
3. Has appellant shown that he is entitled to the abatement of the accuracy-related penalty for the 2004 and 2005 tax years?

FACTUAL BACKGROUND

1. Appellant owned and operated a concert venue known as SOMA San Diego (SOMA) as a sole proprietorship during 2003, 2004, and 2005. Appellant reported income and losses from SOMA on his federal form Schedule C (Profit or Loss from Business) for the tax years at issue. For 2003, appellant reported a net profit on Schedule C of \$1,344. For 2004 and 2005, he reported net losses of \$18,237 and \$4,640, respectively.
2. Appellant's California income tax returns for the three years at issue were all filed late. Appellant's 2003 return was filed on August 26, 2005; his 2004 return was filed on March 14, 2006; and his 2005 return was filed on March 9, 2007.
3. FTB audited appellant's tax returns for 2003, 2004, and 2005 and determined that appellant's business and financial records were incomplete. Due to the lack of adequate records, FTB examined the deposits to appellant's Bank of America business account and credit card records as a basis for estimating appellant's income.
4. FTB determined appellant underreported his income in each of the disputed tax years and issued Notices of Proposed Assessment (NPAs) on April 12, 2010.
5. Appellant protested the NPAs, and the amount of proposed additional tax was adjusted based upon information provided by appellant. However, additional tax was still proposed and FTB issued Notices of Action on July 5, 2017.

² In addition to the issues set forth below, appellant has raised various procedural issues concerning the Office of Administrative Hearings, the Board of Equalization (BOE), the California Department of Tax and Fee Administration, the Office of Tax Appeals (OTA), and the relationships between these agencies and the FTB. These issues are beyond the scope of this appeal, and the OTA has no authority to resolve such matters. The power of the OTA is limited to determining the correct amount of appellant's California income tax liability for the years on appeal. (*Appeal of Fred R. Dauberger, et. al.*, 82-SBE-082, Mar. 31, 1982.) For that reason, appellant's procedural contentions are not discussed in this decision. We note for the record that the Office of Administrative Hearings, the BOE, and the California Department of Tax and Fee Administration have no connection with this appeal.

6. This timely appeal followed.

DISCUSSION

Issue 1 - Has appellant shown any error in FTB's proposed assessments of additional tax for the 2003, 2004, and 2005 tax years?

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.) The bank deposits method used by FTB in this case has been approved by federal courts and by the BOE, which is the predecessor agency for OTA. (*See Doll v. Glenn* (6th Cir. 1956) 231 F.2d 186, 188; *Appeal of Charles R. Rietz*, 85-SBE-045, Apr. 9, 1985.) Because the FTB established a rational basis for its determination, it is presumed correct, and the taxpayer has the burden of proving error. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Michael E. Myers*, 2001-SBE-001, May 31, 2001.)

When FTB's determination is presumed correct, unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof to overcome the presumption. (*Appeal of Aaron and Eloise Magidow*, 82-SBE-274, Nov. 17, 1982.) A taxpayer's failure to produce evidence that is within his control gives rise to a presumption that such evidence, if provided, would be unfavorable to the taxpayer's case. (*Appeal of Don S. Cookston*, 83-SBE-048, Jan. 3, 1983.)

Income tax deductions are a matter of legislative grace, and taxpayers have the burden of proving that they are entitled to the deductions that they claim. (*New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435, 440; *Appeal of James C. and Monablance A. Walshe*, 75-SBE-073, Oct. 20, 1975.) FTB's denials of deductions are presumed correct. (*Appeal of Gilbert W. Janke*, 80-SBE-059, May 21, 1980.) To carry their burden of proof, taxpayers must point to an applicable statute and show by credible evidence that the deductions they claim come within its terms. (*Appeal of Robert R. Telles*, 86-SBE-061, Mar. 4, 1986.)

FTB's proposed tax for each year was based on a combination of an increase in income and a determination of the deductibility of various claimed business expenses. As to its determination of income, the primary basis was its determination of total gross receipts from SOMA based on its examination of bank deposits and credit card receipts showing unreported deposits of \$176,566, \$723,182 and \$1,012,390 for years 2003, 2004 and 2005 respectively. As to 2003, at the conclusion of appellant's protest examination, appellant acknowledged that the

income determination and methodology were reasonable but continued to contest the determinations for 2004 and 2005. In this appeal, appellant's contention about the amount of gross income at issue, is that the proposed assessments should all be struck down as unreasonable based on the assertion that the assessments were arbitrary and unreasonable due to the lack of credible evidence supporting its determination (citing, *Appeal of Roland Aranda Garcia*, 86-SBE-053, Mar. 4, 1986). As support for that position, appellant advanced the view that his lifestyle³ was inconsistent with earning income in amounts proposed by FTB and that the increase from 2002 to the significantly higher 2003 and 2004 amounts was unsupportable, thus making FTB's reliance on bank records unreliable.

We first note that the methodology used to determine appellant's unreported income in this case was the same for all years. Appellant's acceptance of the methodology and result for one year makes it challenging to understand the substance of appellant's argument beyond dissatisfaction with results. In explanation of the basis for an increase in income over the appeal years, we note the significant increase in bank deposits, suggesting a significant increase in SOMA business activity. The test for determining the reasonableness of FTB's determination is whether there is credible evidence to support the calculation, and in this case, there is ample credible evidence in the form of the bank records and credit card records. While we acknowledge that in *Appeal of Roland Aranda Garcia, supra*, the BOE found an assessment partially invalid when based on unreliable testimony of an informant, the BOE also found the assessments at issue partially valid when reliable information served as the basis for FTB's estimates of income. Here, we find the methodology applied by FTB to determine appellant's unreported gross income to be reasonable, consistent with existing law, and its determination entitled to the presumption of correctness.

In this appeal, appellant has failed to meet his burden of proof by showing any error in FTB's determination of gross income. Appellant has made numerous lifestyle assertions, but he has not provided reliable evidence to prove those assertions. Appellant has not directly addressed the unreported bank deposits on which FTB based its proposed assessments. The short answer to appellant's lifestyle argument (for which conflicting facts have been presented by the parties) is that FTB is not required to show just where and how appellant spent the

³ Appellant's assertions in support of his conclusion that FTB's gross income determinations are unreasonable include low income in the early 2000s, a lifestyle that included living in a modest apartment, driving old cars. These assertions predate the appeal years and predate appellant's ownership of SOMA.

unreported income. It is enough that its determination is clearly supported by the evidence,⁴ and in this appeal we have found that to be the case.

Appellant also contests FTB's disallowance of several deductions in its determination of taxable income, including depreciation for leasehold improvements, legal fees, and promotional expenses.

Regarding legal fees and promotional expenses, the record includes no evidence of actual payment of such expenses (no cancelled checks or money orders, no credit card receipts, no bank statements, no credit card statements, no payment receipts from vendors, no statements or invoices from vendors showing payments received, no affidavits from vendors, employees, or witnesses concerning payments, no business books, journals, and ledgers or check registers showing payments for these expenses). Appellant asserts that common sense dictates that attorney fees billed, as reflected in a statement provided, would have been paid. However, if paid by appellant some evidence should be available, yet none has been provided. During the protest process appellant was able to substantiate that a portion of legal fees originally disallowed at audit was paid during the appeal years, and FTB allowed that deduction. Since some amounts could be substantiated, it is not reasonable to conclude that unsubstantiated payments for legal fees incurred were also paid in the appeal years. The same lack of documentation exists with respect to claimed promotional expenses in the appeal years. While appellant has provided a contract for an event scheduled in 2006, he has not shown a payment in 2005 of the required deposit.

Regarding depreciation deductions in 2003, 2004 and 2005 for costs incurred as leasehold improvements/renovations to the SOMA facility, we find appellant's documentation adequate to support these deductions. Plans provided show the anticipated renovations necessary to convert an abandoned movie theater into a concert hall. Appellant contends that "receipts previously provided to the FTB at audit show that Len Paul spent at least \$92,463 for these renovations." However, the record in this appeal does not include receipts, per se, nor have cancelled checks been provided. However, a settlement agreement with a contractor, dated September 20, 2002, involving the resolution of a dispute over construction services provided at SOMA has been provided. In that agreement, payments totaling \$61,406 were agreed to be paid by appellant. Since SOMA actually opened as a concert venue, it is reasonable to conclude the

⁴ *Tharp v. Commissioner* (1990) 57 T.C.M. 1190 at p. 1205.

renovations occurred and that appellant paid the agreed amount. It may also be reasonable to assume additional costs may have been paid since appellant did provide construction plans and engineer correspondence, but that documentation did not show any specific amount was billed or paid. Since the burden of proof is on appellant to establish the amount of an allowable deduction, we cannot estimate the amount of additional costs to allow, and give no value to common sense assumptions, without some supporting documentation as to amounts expended. Here we find that appellant has met his burden to establish amortization deductions for the leasehold improvements in the amount of \$61,406, with amortization of that amount over 15 years commencing in 2003.

Except as noted above, we find appellant has not met his burden to show error in FTB's proposed assessments for 2003, 2004 or 2005.

Issue 2: Has appellant established reasonable cause for the late filing of his tax returns for the three years at issue?

Section 19131 provides that a late-filing penalty shall be imposed when a taxpayer fails to file a tax return on or before its due date, unless the taxpayer establishes that the late filing was due to reasonable cause and was not due to willful neglect. To establish reasonable cause, the taxpayer "must show that the failure to file timely returns occurred despite the exercise of ordinary business care and prudence, or that cause existed as would prompt an ordinary intelligent and prudent businessman to have so acted under similar circumstances." (*Appeal of Howard G. and Mary Tons*, 79-SBE-027, Jan. 9, 1979.)

Here, it is undisputed that appellant filed his tax returns for the years at issue in an untimely manner. Appellant has not explained, and the evidence does not show, why the returns were filed late. Appellant has not disputed the amount of the late filing penalties or the calculation method. We have no evidentiary basis to conclude that appellant had reasonable cause for the late filing of his returns for the years at issue, so we have no legal grounds to abate these penalties.

Issue 3: Has appellant shown that he is entitled to the abatement of the accuracy-related penalties for the 2004 and 2005 tax years?

Section 19164, which incorporates the provisions of Internal Revenue Code (IRC) section 6662, provides for an accuracy-related penalty of 20 percent of the applicable underpayment.

The penalty applies to the portion of the underpayment attributable to (1) negligence or disregard of rules and regulations, or (2) any substantial understatement of income tax. (IRC, § 6662(b).) “Negligence” is defined to include “any failure to make a reasonable attempt to comply” with the tax rules. (IRC, § 6662(c).) For an individual, there is a “substantial understatement of income tax” when the amount of the understatement exceeds the greater of ten percent of the tax required to be shown on the return for that tax year, or \$5,000. (IRC, § 6662(d)(1).)

There are three exceptions to the imposition of the accuracy-related penalty. Under the first exception, the accuracy-related penalty will be reduced by the portion of the understatement attributable to the tax treatment of any item if there is substantial authority for such treatment. (IRC, § 6662(d)(2)(B).) Under the second exception, the penalty will be reduced by the portion of the understatement attributable to the tax treatment of any item if the relevant facts affecting the item’s tax treatment are adequately disclosed and there is a reasonable basis for the tax treatment of such item. (IRC, § 6662(d)(2)(B).) Under the third exception, the penalty will not be imposed to the extent that a taxpayer shows that a portion of the underpayment was due to reasonable cause and that the taxpayer acted in good faith with respect to such portion of the underpayment. (IRC, § 6664(c)(1); Treas. Regs. §§ 1.6664-1(b)(2) & 1.6664-4.)

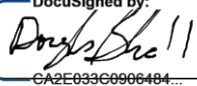
In this appeal, appellant has not argued, and the evidence does not show, that any of the statutory exceptions to the accuracy-related penalty might apply to 2004 and 2005, the two years where it was imposed by FTB. It appears that the penalty amount was correctly calculated for both years, and appellant has not disputed the amount. Therefore, we have no legal basis for the abatement of the accuracy-related penalties for 2004 or 2005.

HOLDINGS

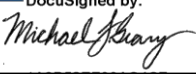
1. Appellant has not shown any error in FTB’s proposed assessments of additional tax due for the 2003, 2004 and 2005 tax years except for its disallowance of the leasehold amortization noted.
2. Appellant has not shown that he is entitled to abatement of the late-filing penalties for tax years 2003, 2004 or 2005.
3. Appellant has not shown that he is entitled to abatement of the accuracy-related penalty for the 2004 and 2005 tax years.


DISPOSITION

FTB's proposed assessments are modified to allow additional amortization deductions in tax years 2003, 2004 and 2005 and are otherwise sustained.

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Douglas Bramhall
Administrative Law Judge

We concur:

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Michael F. Geary
Administrative Law Judge

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Teresa A. Stanley
Administrative Law Judge