OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18011090
	)
C. POST	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant: Kevan P. McLaughlin, Esq., LLM

For Respondent: Natasha S. Page, Tax Counsel IV

For Office of Tax Appeals: Mai C. Tran, Tax Counsel IV

D. BRAMHALL, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, C. Post (appellant) appeals an action by the respondent Franchise Tax Board (FTB) proposing additional tax, plus interest, for the 2008, 2009, and 2010 tax years.[1]

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

ISSUE

Whether appellant has shown error in FTB's proposed assessments of additional tax based on final federal determinations.

FACTUAL FINDINGS

1. Appellant filed an untimely California tax return for the 2008 tax year on July 26, 2010. On the return, appellant reported federal adjusted gross income (AGI) of negative $19,534, no California adjustments, and no taxable income or California tax. Since appellant reported no withholding, appellant did not pay tax or receive a refund for the 2008 tax year.

[1] FTB also proposed the imposition of the accuracy-related and late-filing penalties. Appellant has not addressed the penalties in his appeal or briefs. Therefore, we will not discuss them in this opinion.

2. Appellant filed a timely 2009 California tax return. On the return, appellant reported federal AGI of negative $7,078, no California adjustments, and no taxable income or California tax. Since appellant reported no withholding, appellant did not pay tax or receive a refund for the 2009 tax year.
3. Appellant filed a timely 2010 California tax return. On the return, appellant reported wages of $5,000, federal AGI of $30,451, and, after claiming the standard deduction of $3,670, taxable income of $26,781. Appellant reported California tax of $733. After subtracting the exemption credit of $99 and the renter's credit of $60, appellant reported a tax liability of $574, which he paid with the return.
4. The Internal Revenue Service (IRS) audited appellant's federal tax returns for 2008, 2009 and 2010. As relevant to this appeal, the IRS disallowed Schedule C deductions for certain business expenses and increased appellant's Schedule C business gross receipts for each year.[2] The adjustments resulted in corresponding increases to appellant's self-employment tax and the deduction for such tax for each year. Appellant did not contest the federal audit and entered into an offer in compromise with the IRS for each year.
5. For 2008, the IRS disallowed deductions for car/truck expenses of $17,549 and "other expenses" of $22,510.[3] The "other expenses" included $310 in bank fees. The IRS also increased business gross receipts by $198,311 and imposed an accuracy-related penalty of $14,166.
6. For 2009, the IRS disallowed deductions for car/truck expenses of $14,548, legal and professional services of $3,200, advertising expenses of $11,400, and "other expenses" of $17,890.[4] The IRS also increased business gross receipts by $79,551 and imposed an accuracy-related penalty of $8,636.80.
7. For 2010, the IRS disallowed deductions for car/truck expenses of $15,945, legal and professional services of $4,250, rent/lease expenses of $4,200, contract labor expenses[5]

[2] On the Schedules C, appellant reported his trade or business as "other personal services."

[3] For 2008, the IRS disallowed the entire amount of other expenses claimed by appellant.

[4] For 2009, appellant deducted $23,103 in "other expenses" on his Schedule C. The IRS allowed a partial deduction of $5,213.

[5] The IRS and FTB erroneously referred to the contract labor expense as commission and fees. FTB clarifies that appellant reported the expense as contract labor.

of $74,696, and "other expenses" of $7,580.[6] The IRS also increased business gross receipts by $36,933 and imposed an accuracy-related penalty of $9,789.

8. FTB received information from the IRS regarding these federal adjustments and made corresponding adjustments to appellant's California tax returns. FTB issued Notices of Proposed Assessment dated October 27, 2014, for the years at issue, which disallowed the car/truck expenses, legal and professional fees, advertising, rent/lease, contract labor, and other expenses, and increased appellant's business gross receipts.

9. Appellant timely protested. Appellant provided FTB with some documentation to challenge the accuracy of the federal adjustments. After review, FTB affirmed the proposed assessments by issuing Notices of Action dated September 28, 2015, for 2008 and 2009 and a Notice of Action – Affirmation dated October 8, 2015, for 2010.

10. Appellant then filed this timely appeal. While this appeal was pending, appellant submitted additional information, including partial bank statements and cancelled checks for the years at issue. Appellant did not provide any source documentation, such as invoices, contracts, or receipts for the claimed expenses.

11. According to appellant's federal account transcripts dated March 19, 2019 and March 21, 2019, the IRS did not cancel the federal adjustments based on the disallowed claimed deductions and increase in business gross receipts for any of the years at issue.

DISCUSSION

R&TC section 18622(a) requires a taxpayer to concede the accuracy of a federal change to a taxpayer's income or to state where the change is erroneous. It is well-settled that a deficiency assessment based on a final federal determination is presumed to be correct and a taxpayer bears the burden of proving that FTB's determination is erroneous. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Brockett* (86-SBE-109) 1986 WL 22731.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Magidow* (82-SBE-274) 1982 WL 11930.)

Deductions from gross income are a matter of legislative grace and a taxpayer has the burden of proving entitlement to the deductions claimed. (*New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435; *Appeal of Walshe* (75-SBE-073) 1975 WL 3557.) To carry the

[6] For 2010, appellant deducted $9,070 in "other expenses" on his Schedule C. The IRS allowed a partial deduction of $1,490.

burden of proof, a taxpayer must point to an applicable statute and show by credible evidence that the deductions claimed come within its terms. (*Appeal of Telles* (86-SBE-061) 1986 WL 22792.) A taxpayer must retain sufficient records to substantiate claimed deductions. (*Sparkman v. Commissioner* (9th Cir. 2007) 509 F.3d 1149, 1159; Treas. Reg. § 1.6001-1(a); *Patterson v. Commissioner*, T.C. Memo. 1979-362 [disapproving the "shoebox method" of recordkeeping].)

Internal Revenue Code (IRC) section 162 provides, in pertinent part, that there shall be allowed as a deduction all the ordinary and necessary business expenses paid or incurred during the taxable year in carrying on any trade or business.[7] The expenses must be directly connected to or pertain to the taxpayer's trade or business. (Treas. Reg. § 1.162-1(a).)

In addition, IRC section 274(d) imposes strict substantiation requirements for certain types of expenses, including business mileage.[8] IRC section 274(d) requires a taxpayer to substantiate expenses by adequate records or other corroborating evidence of (1) the amount of each use (here, the mileage), (2) the time and place of the use, and (3) the business purpose of the use.[9] Expenses subject to the strict substantiation requirements of IRC section 274(d) are disallowed in full unless the taxpayer satisfies each element of those requirements. (*Fleming v. Commissioner*, T.C. Memo. 2010-60.)

Appellant has not shown that the IRS changed or eliminated the federal adjustments to income or expenses made for tax years 2008, 2009 or 2010. Further, the most recent federal account transcripts reflect that appellant did not dispute any of the federal adjustments.[10] Accordingly, FTB's proposed assessments based on these federal adjustments is presumptively correct and it is appellant's burden to show error in those determinations.

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[7] IRC section 162 is incorporated into California law by R&TC section 17201.

[8] IRC section 274(d) is incorporated into California law by R&TC section 17201.

[9] Treasury Regulation section 1.274-5T(c)(2)(i) provides that a taxpayer will have maintained "adequate records" if he maintains a contemporaneous log or diary, combined with supporting documents, which substantiate the required elements of the expense, such as the amount, date and business purpose of the item. Alternatively, the taxpayer must establish each element of the expense by his own statement containing specific detail as to each element, and "other corroborative evidence sufficient to establish such element" (Treas. Reg. § 1.274-5T(c)(3)(i)(B)) or other evidence, with respect to each element, possessing "the highest degree of probative value possible under the circumstances" (Treas. Reg. § 1.274-5T(c)(4)(iii)).

[10] While none of the adjustments were contested, evidence does establish that appellant entered into an offer in compromise agreement with the IRS.

Appellant also has not shown that FTB's adjustments based on the federal adjustments were incorrect. However, regarding the disallowed bank fees of $310 claimed as "other expenses" for 2008, we find that the bank statements support appellant's claimed expenses of $310 as a business expense.

With regard to the car/truck and business mileage expenses, appellant has not satisfied the heightened standard for substantiation pursuant to IRC section 274(d). Appellant did not provide any business mileage records showing the mileage driven, or the date, the destination, and business purpose for each use. Instead, appellant provided copies of bank statements showing payments to gas stations. Bank statements alone are not sufficient to show the business purpose of the expense. For the remaining disallowed expenses, appellant has not provided adequate evidence in substantiation of his claimed business expenses. While appellant submitted bank statements and cancelled checks as evidence for certain expense amounts incurred, appellant produced no evidence to show the nature of these expenses or how they relate to his business.[11] While appellant submitted schedules that break down the expenses by purpose, appellant has not provided any documentation that verifies the information in the schedules. For example, appellant provided no invoices, agreements, leases or other contracts to substantiate the amount and purpose of the disallowed legal and professional expenses, advertising, contract labor/commission expenses or rent/lease expenses. In addition, the total amounts listed on the schedules are not consistent with the amount of deductions reported on appellant's Schedule C. As such, appellant has not shown that the claimed expenses were ordinary and necessary business expenses directly related to appellant's trade or business.[12]

Further, the IRS already allowed a portion of the "other expenses" deduction claimed by appellant in 2009 and 2010 in this appeal. Since respondent's proposed assessments followed

[11] We note that appellant provided certain checks referencing rental payments, but it is unclear whether it is a rental payment for business or personal use. In addition, appellant provided certain checks referencing attorney's fees, but it is unclear whether the fees were for business or personal use.

[12] The *Cohan* rule allows for the use of a reasonable estimate when the taxpayer presents credible evidence that there were some legitimate expenses, but the taxpayer's records are inadequate to document the expenses in detail. (*Cohan v. Commissioner* (2d Cir. 1930) 39 F.2d 540.) If there is sufficient evidence indicating the taxpayer incurred a deductible expense, but the precise amount of that deduction cannot be determined, a court or other finder of fact may make an approximation of the amount of the deduction "bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making." (See *Cohan v. Commissioner*, *supra*, at pp. 543-544.) However, the *Cohan* rule does not apply to expenses subject to IRC section 274(d) substantiation rules. (*Fleming v. Commissioner*, *supra*, T.C. Memo. 2010-60.) Appellant has not shown that the claimed expenses (other than the bank fees) were documented business expenses, and therefore, the *Cohan* rule is not applicable.

the federal adjustments, respondent has already allowed a portion of the claimed "other expenses" deduction. Appellant has not shown which of the "other expenses" have already been allowed and which have not. As we cannot determine which of appellant's expenses that were allowed as a deduction for "other expenses" from the record on appeal, the allowance of any further deductions may result in duplicate deductions. Tax administrators are not required to comb through appellant's disorganized records and guess which relate to claimed deductions. (See *Patterson v. Commissioner*, *supra*, T.C. Memo. 1979-362.) Since appellant has not differentiated between those "other expenses" which already have been allowed as deductions and those which have not, he has not shown that he is entitled to additional "other expenses" deductions.

As for the federal adjustments based on additional business gross receipts, appellant states that the IRS completed a bank deposit analysis as part of the federal audit. Documentation provided purports to replicate the federal audit results. However, appellant acknowledges that some information may not be currently available for years after 2008. For 2008, appellant reported $37,500 in gross receipts on his Schedule C. According to appellant's bank statements from three bank accounts, his gross receipts were $236,397.20.[13] The difference between the gross receipts reported on appellant's bank statements and those reported on appellant's Schedule C is $198,897.20. The IRS increased appellant's gross receipts by $198,311. We find the results of the information provided by appellant appears reasonable when compared to the IRS results.

Appellant next contends that many of the bank deposits in 2008 were nontaxable transfers between bank accounts totaling $16,186. We find that appellant has substantiated $13,900 in nontaxable transfers as follows: 1) check #4078 from appellant's Bank of America (BoA) account, appellant transferred $9,000 from BoA to his Washington Mutual (Wamu) account on April 3, 2008; 2) check #100 from appellant's Wamu account, appellant transferred $2,000 from his Wamu account to his BoA account on May 1, 2008; 3) cashier's check from Wamu, transferred $900 from his Wamu account to his BoA account on May 5, 2008; and 4) check #4059 from appellant's BoA account, appellant transferred $2,000 to his Wamu account on August 4, 2008. While appellant also claims various cash deposits as nontaxable transfers,

[13] Appellant had two accounts at Bank of America and one account at Washington Mutual Bank.

we are unable to verify the source of the cash deposits. Accordingly, we find that appellant has shown that the adjustment for gross receipts for 2008 should be reduced by $13,900.

For 2009, appellant reported $78,500 of gross receipts on his Schedule C. According to appellant's bank statements, his gross income was $149,866.80. The difference between the gross receipts reported on appellant's bank statements and those reported on appellant's Schedule C is $71,366.80. The IRS increased appellant's gross receipts by $79,551. Appellant only provided 2009 bank statements for one of three bank accounts appellant used in 2008. According to a check from one of his BoA accounts (#10888), he closed this account on October 15, 2008. However, appellant contends that any other bank account information is either from closed accounts he used in 2008 or is no longer available. Accordingly, we find the information provided to be unpersuasive and that appellant has not shown error in the federal or FTB adjustment for gross receipts for 2009.

For 2010, appellant reported gross receipts of $146,255 on his Schedule C. According to appellant's bank statements, his gross receipts were $129,913.55. The difference between the gross receipts reported on appellant's bank statements and those reported on appellant's Schedule C is negative $16,341.45. However, the IRS increased appellant's reported gross receipts by $36,933. Appellant only provided 2010 bank statements for one of three bank accounts appellant used in 2008. According to a check from one of his BOA accounts (#10888), he closed this account on October 15, 2008. However, as with 2009 information provided by appellant, we are unable to verify whether appellant only used the one bank account for his business activity. As a result, we find that appellant has not shown error in the IRS gross receipts adjustment or in FTB's reliance on that adjustment in determining its proposed assessment for 2010.

Appellant further contends that for 2008, 2009 and 2010, some of the deposits should be reduced by commission payments paid to others. However, those payments would be considered deductions as opposed to reductions to gross receipts, and as discussed above, appellant has not provided substantiation that any of those payments are qualified business expenses. As such, appellant has not shown error in the federal adjustment for gross receipts for 2008, 2009 or 2010.

HOLDING

For 2008, we find that appellant has substantiated $310 for a deduction for bank fees as part of "other expenses" and appellant has shown that gross receipts should be reduced by $13,900. Appellant has not demonstrated any further errors in the federal adjustments, or in FTB's corresponding proposed assessments for 2008, 2009, and 2010.

DISPOSITION

FTB's proposed assessment for the 2008 tax year is modified to allow for a deduction of $310 in bank fees and a reduction of $13,900 in business gross receipts. FTB's action is otherwise sustained.

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Douglas Bramhall
Administrative Law Judge

We concur:

DocuSigned by:
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Linda C. Cheng
Administrative Law Judge

DocuSigned by:
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Kenneth Gast
Administrative Law Judge

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