OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18042907
MELVIN J. SURDIN AND KATHERINE D. CHENG SURDIN	)

OPINION

Representing the Parties:

For Appellants: Melvin J. Surdin and Katherine D. Cheng Surdin

For Respondent: Eric A. Yadao, Tax Counsel III

A. ROSAS, Administrative Law Judge: Under Revenue and Taxation Code (R&TC) section 19045, appellants Melvin J. Surdin and Katherine D. Cheng Surdin appeal respondent Franchise Tax Board's actions proposing additional taxes of $3,848 (2011), $3,043 (2012), and $5,726 (2013), plus applicable interest.

Appellants waived their right to an oral hearing; therefore, we decide this matter based on the written record.

ISSUE

Did appellants show error in respondent's proposed assessments, which are based on a final federal determination?

FACTUAL FINDINGS

1. Appellants timely filed joint California resident income tax returns for tax years 2011, 2012, and 2013. In addition to W-2 wages of $191,103 (2011), $177,907 (2012) and $181,9925 (2013), appellants reported gross receipts or sales of $1,850 (2011), $2,375 (2012), and $1,200 (2013) on Schedule C. These earnings related to Surdin Photography, their self-described "stock photography business." Appellants also claimed Schedule C

deductions of $35,917 (2011), $35,098 (2012), and $35,003 (2013) from Surdin Photography.[1]

2. Subsequently, the Internal Revenue Service (IRS) provided information to respondent concerning the federal examination of appellants' tax returns for 2011, 2012, and 2013. After disallowing deductions and including additional taxable income, the IRS assessed additional tax for each year. Specifically, the IRS disallowed appellants' Schedule C deductions. The IRS also moved the stock photography income from Schedule C to the "Other Income" line on Form 1040 and adjusted the self-employment tax to zero. Although the IRS made some adjustments to Schedule A,[2] most of the adjustments concerned Schedule C income and deductions related to Surdin Photography. In January 2015, appellants and the IRS agreed to a settlement, which reduced the amount of additional taxes and eliminated the penalties.[3] The IRS amounts are as follows:

	IRS Adjustments to Taxable Income	Additional Tax Due (IRS examiner report)	IRS settlement
2011	$42,108	$10,947 + penalties	$10,529
2012	$34,446	$9,217 + penalties	$8,614
2013	$67,131	$16,083 + penalties	$15,493

3. Based on the IRS's federal examination and taking into consideration the settlement that the IRS reached with appellants, respondent made corresponding adjustments to appellants' tax accounts for 2011, 2012, and 2013 and issued three Notices of Proposed Assessment (NPAs) dated March 4, 2016. In relevant part, the proposed assessments are as follows:

	Proposed Additional Taxable Income	Proposed Additional Tax Due
2011 NPA	$41,381	$3,848
2012 NPA	$32,773	$3,043
2013 NPA	$66,934	$5,726

[1] Appellants argue that the amounts claimed on Schedule C constituted ordinary and necessary business deductions. In contrast, the IRS concluded that the activity described on Schedule C did not constitute the carrying on of a trade or business and that appellants did not show that they actually paid or incurred these claimed expenses. Appellants explained that the IRS disallowed these expenses because the IRS "deemed our stock photography business 'a hobby.'"

[2] For example, the IRS adjusted appellants' real estate tax deduction by -$765 (2011) and appellants' home mortgage interests and points deduction by -$3,384 (2011), -$3,599 (2012), and $28,001 (2013).

[3] Appellants argue that they settled with the IRS solely for economic reasons, not because appellants agreed with the IRS's position. However, a taxpayer's motivation for accepting a federal adjustment is not relevant to the issue of whether the federal adjustment was correct. (See *Appeal of Schalman* (78-SBE-090) 1978 WL 3563.)

4. Appellants protested the three NPAs.
5. In subsequent correspondence, respondent acknowledged appellants' protest of the NPAs. The correspondence explained that respondent based the NPAs on the IRS appeal results, which the IRS neither cancelled nor reduced. Respondent stated that if appellants disagreed with the NPAs, they would need to resolve the issue with the IRS because California law is the same as federal law for the issues involved. Respondent gave appellants until May 19, 2017, to provide respondent with a revised IRS audit report or any additional information to consider.
6. Appellants timely responded and included information regarding the settlement between appellants and the IRS. However, as respondent later explained to appellants, respondent had already considered the settlement information when it issued the NPAs. Respondent extended the due date for appellants to provide evidence of any IRS adjustments or reconsideration. Appellants timely responded and resubmitted the same information.
7. Respondent issued three Notices of Action dated January 10, 2018, which affirmed the corresponding NPAs, and appellants filed this timely appeal.[4]

DISCUSSION

It is well settled that a deficiency assessment based on a federal audit report is presumptively correct and that the taxpayer bears the burden of proving that the determination is erroneous. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509.) A taxpayer shall either concede the accuracy of a federal determination or state wherein it is erroneous. (R&TC, § 18622(a).) Income tax deductions are a matter of legislative grace and a taxpayer who claims a deduction has the burden of proving by evidence that he or she is entitled to that deduction. (See *New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435, 440.)

The applicable burden of proof is by a preponderance of the evidence. (Evid. Code, § 115; *Appeal of Estate of Gillespie*, 2018-OTA-052P, at p. 4.) That is, a party must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Concrete Pipe and Products of California, Inc. v. Construction Laborers Pension Trust for Southern California* (1993) 508 U.S. 602, 622.) To carry the burden of proof, the taxpayer must point to an applicable statute and show by credible evidence that the deductions claimed

[4] Appellants' arguments can be summarized as follows: they disagree with the IRS's disallowance of business-related deductions and the IRS's determination that these losses were hobby losses.

come within its terms. (*Appeal of Telles* (86-SBE-061) 1986 WL 22792.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Magidow* (82-SBE-274) 1982 WL 11930.)

Here, respondent based its proposed assessments of additional taxes on the IRS's final audit determinations. The IRS disallowed certain deductions and adjusted the 2011, 2012, and 2013 tax returns by increasing appellants' taxable income and assessing additional taxes. Specifically, the IRS disallowed appellants' Schedule C deductions and also made adjustments to Schedule A. Appellants did not address the IRS's adjustments to Schedule A. As to the Schedule C adjustments, appellants explained that the IRS disallowed these deductions because the IRS deemed that appellants' "stock photography business" constituted a hobby.

A taxpayer may deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." (Int.Rev. Code, § 162(a).)[5] In general, however, with an activity not engaged in for profit, such as a hobby, a taxpayer may only claim a deduction up to the amount of the income generated by that activity. (Int.Rev. Code, § 183.)[6] An "*activity not engaged in for profit* means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 . . . ." (Treas. Reg. § 1.183-2(a), emphasis in original.)

Although Internal Revenue Code section 162 does not expressly require that a trade or business must be carried on with an intent to profit, the United States Supreme Court has ruled that a taxpayer's activity falls within the scope of this statute only if an intent to profit has been shown. (*Commissioner v. Groetzinger* (1987) 480 U.S. 23, 35 [To "be engaged in a trade or business, . . . the taxpayer's primary purpose for engaging in the activity must be for income or profit"].) An activity is presumed to be engaged in for profit if the activity produces gross income in excess of deductions for any three of the five consecutive years which end with the taxable year, unless the Commissioner establishes to the contrary. (Int.Rev. Code, § 183(d); see *Wadlow v. Commissioner* (1999) 112 T.C. 247, 250.) Here, there is no evidence that appellants' stock photography activity produced gross income in excess of deductions for any year, let alone for any three of the five consecutive years which end with 2011, 2012, or 2013.

[5] California generally conforms per R&TC section 17201(a).

[6] California generally conforms per R&TC section 17201(a).

Furthermore, the Treasury Regulations provide a non-exhaustive list of factors to consider in evaluating a taxpayer's intent to profit. (Treas. Reg. § 1.183-2(b).)[7] Based on the lack of evidence, this panel is unable to evaluate appellants' profit objective. The facts merely establish that, in the tax years at issue, appellants reported gross receipts or sales of $1,850 (2011), $2,375 (2012), and $1,200 (2013) from Surdin Photography; and that for each tax year, appellants also claimed over $35,000 in deductions on Schedule C.

However, even if we were to assume that appellants had the requisite intent to profit, appellants still fail to substantiate their claimed deductions. To qualify as an allowable business deduction, an item must (1) be paid or incurred during the taxable year, (2) be for carrying on any trade or business, (3) be an expense, (4) be a necessary expense, and (5) be an ordinary expense. (*Commissioner v. Lincoln Savings & Loan Assn*. (1971) 403 U.S. 345, 352.)

But appellants provided no evidence to show that they actually paid or incurred any of the claimed deductions and, moreover, that any of the claimed deductions were for ordinary and necessary expenses in carrying on a trade or business. As to appellants' argument that the claimed losses were not hobby losses, appellants do not provide any evidence in support of their position; instead, appellants merely make the conclusory argument that they were engaged "in a regular business not a 'hobby business.'" Appellants argue that they submitted a "receipt for each and every business expense" to the IRS; and although this may be true, appellants did not show that they also provided these receipts to respondent (during the protest or this appeal). Furthermore, at no time did appellants submit these receipts as evidence to the Office of Tax Appeals. Additionally, while appellants' arguments seem to focus on the denial of their claimed Schedule C deductions, they fail to address the IRS's adjustments to Schedule A itemized deductions (i.e., adjustments to property taxes and mortgage interest deductions).

[7] These factors include: (1) the manner in which the taxpayer carried on the activity; (2) the expertise of the taxpayer or his or her advisers; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that the assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or loss with respect to the activity; (7) the amount of occasional profits earned, if any; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or recreation were involved. (Treas. Reg. § 1.183-2(b).) No single factor is determinative of the taxpayer's intention to make a profit, and more weight may be given to some factors than others. (*Golanty v. Commissioner* (1979) 72 T.C. 411, 426.)

Appellants have the burden of proving error in respondent's proposed assessments or the federal adjustments upon which respondent based its assessments. Although appellants assert that they disagree with the proposed assessments, they provided no evidence to support their position. Thus, appellants failed to meet their burden of proving error in respondent's proposed assessments.

HOLDING

Appellants did not show error in respondent's proposed assessments for the 2011, 2012, and 2013 tax years, which were based on final federal determinations.

DISPOSITION

We sustain respondent's proposed assessments in full.

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Alberto T. Rosas
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Alberto T. Rosas
Administrative Law Judge

We concur:

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Andrew J. Kwee
Administrative Law Judge

DocuSigned by:
Amanda Vassigh
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Amanda Vassigh
Administrative Law Judge

Date Issued: 2/5/2020