

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:

A. DAKERS) OTA Case No. 19034411
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)**OPINION**

Representing the Parties:

For Appellant:

A. Dakers

For Respondent:

Mira Patel, Tax Counsel

A. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, A. Dakers (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing tax of \$5,515.00 and a late-filing penalty of \$1,378.75, plus interest, for the 2016 tax year.

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

ISSUES

1. Whether appellant derived income from a California source that required him to file a 2016 nonresident return.
2. Whether appellant has established reasonable cause for failing to timely file a 2016 return.

FACTUAL FINDINGS

1. Appellant entered into an agreement with Host Analytics, Inc. (Host Analytics) to provide staffing services for Host Analytics. The contract begins by stating: “This agreement is by and between: Host Analytics, Inc. (HAI) and [A.] Dakers, dba MA Consulting Solutions, whose address is . . . Los Angeles, CA 90024, referred to in this agreement as ‘Staffing Agency.’” Under the agreement, “[t]he consulting fee for a

successful contingency search by [appellant] that will be charged to [Host Analytics] is at the rate of 20% of the first year base salary per person hired (the ‘Amount Due’).” The agreement provides that appellant is an independent contractor. The agreement also indicates that Host Analytics has an address in Redwood City, California,¹ and it is signed and dated by appellant and an individual who appears to be the head of human resources at Host Analytics.

2. Appellant was a California nonresident for the tax year at issue and provided his services to Host Analytics while residing in the state of Texas. Host Analytics issued to appellant a Form 1099-MISC that reported \$28,000 as compensation for his services in 2016.²
3. FTB sent a Request for Tax Return (Request) dated May 3, 2018, to appellant, stating that it received information from the Internal Revenue Service (IRS) indicating that during 2016, appellant filed a federal return with a California address. The Request required appellant to file a 2016 return, provide proof that he previously filed a return, or explain why he was not required to file a return.
4. Appellant filled out the form attached to the Request, stating that he lived in Texas and used a California address “for certain things including correspondence with IRS.” Appellant also indicated that he was not in California during 2016 for any amount of time.
5. FTB responded by letter, stating that appellant must file a 2016 nonresident return. On December 17, 2018, FTB issued a Notice of Proposed Assessment (NPA) with an estimated California adjusted gross income (AGI) based on appellant’s reported federal AGI³ and a standard deduction of \$4,129.⁴ The NPA proposed a total tax liability of \$5,515.00 and a late-filing penalty of \$1,378.75, plus interest.

¹ Appellant produced what appears to be a screenshot of Host Analytics’s website that indicates it has three business locations: (1) Redwood City, California, its headquarters; (2) Reno, Nevada; and (3) Hyderabad, India. Presumably, these were Host Analytics’s only business locations for 2016.

² Neither the agreement nor the record indicates how the \$28,000 was computed.

³ This includes W-2 wages performed while he resided in Texas, \$27,060 of net profit from his sole proprietorship reported on Schedule C (which is the \$28,000 of gross receipts at issue), and various expenses, such as a self-employment tax deduction of \$1,912 and a self-employed health insurance deduction of \$3,040.

⁴ FTB applied the standard deduction for a single individual with no dependents. For the 2016 tax year, a single individual under age 65 with no dependents realizing California gross income of \$16,597 or California AGI of \$13,278 was required to file a California income tax return.

6. Appellant protested the NPA. FTB issued a Notice of Action, affirming the NPA. This timely appeal followed.
7. On appeal, FTB concedes that appellant had California AGI (i.e., California source income) of only \$22,108, which is less than the amount FTB reported on the NPA.⁵ FTB revised its proposed assessment based on the \$22,108, which now shows tax of \$1,320 and a late-filing penalty of \$330.

DISCUSSION

Issue 1. Whether appellant derived income from a California source that required him to file a 2016 nonresident return.

Every individual subject to the Personal Income Tax Law must make and file a return with 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.”

When FTB makes a proposed assessment of additional tax based on an estimate of income, FTB’s initial burden is to show that its proposed assessment is reasonable and rational. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Myers* (2001-SBE-001) 2001 WL 37126924.) 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); see also *Appeals of Bailey* (92-SBE-001) 1992 WL 44503.) 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

⁵ This amount is the \$28,000 of gross receipts from Host Analytics, less related expenses reported on Schedule C of \$940, for a net profit of \$27,060. It appears FTB further reduced the \$27,060 by a self-employment tax deduction of \$1,912 and a self-employed health insurance deduction of \$3,040, to derive the \$22,108 of California source income (or AGI). Based on his 2016 federal Schedule C, which indicates his principal business or profession is “financial consulting,” appellant reported the \$28,000 as his only gross receipts for the year from his sole proprietorship.

income. (See *Palmer v. Internal Revenue Service*, *supra*, at p. 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*.)

California Code of Regulations, title 18, section (Regulation) 17951-4

California imposes a tax on the entire taxable income of a nonresident, such as appellant, to the extent it is derived from California sources within this state. (R&TC, §§ 17041(b), 17951(a).) Gross income of nonresidents from sources within and without California “shall be allocated and apportioned under rules and regulations prescribed by [FTB].” (R&TC, § 17954.) Regulation 17951-4 provides income sourcing provisions applicable to a nonresident’s trade, business, or profession. (See also Cal. Code Regs., tit. 18, § 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(c). Under that regulatory subdivision, 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 business entities. Thus, the requirements for application of Regulation 17951-4(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 without California. (See *Appeal of Bindley*, 2019-OTA-179P.)⁶

There is no dispute that appellant was a California nonresident during the 2016 tax year. Likewise, the uncontroverted evidence establishes that appellant conducted his staffing business as a sole proprietor, which is corroborated by his federal Schedule C reporting the \$28,000 of

⁶ Appellant cites to *Appeal of Larsen*, 2018-OTA-073, a nonprecedential opinion issued by Office of Tax Appeals (OTA), for the proposition that FTB failed to meet its burden of showing that Host Analytics received the benefit of his services solely in California when Host Analytics has locations within and without the state. However, an opinion may not be relied on as authority before OTA unless it has been designated as precedential. (Cal. Code Regs., tit. 18, § 30502(b).) Precedential opinions of OTA may be found on OTA’s website at < <https://ota.ca.gov/opinions> >.

receipts at issue from Host Analytics. Thus, the first and second requirements for application of Regulation 17951-4(c), have been met.

The third requirement of Regulation 17951-4(c) is that appellant must be carrying on a unitary business. In the context of a sole proprietorship, a unitary business is a business, trade, or profession conducted both within and without the state, where the parts conducted within and without 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 business, performed staffing services for Host Analytics. He, thus, conducted a one service business, which only he controlled and managed, and, as far as we can tell from the record, it was one interrelated and interdependent business employing and consuming the same resources. (*Appeal of Bindley, supra*, 2019-OTA-179P at p. 7.) Therefore, the third requirement has been met.

The final requirement is that appellant must have been conducting business within and without California. The record shows that appellant received California source income, discussed below, from Host Analytics, a California-headquartered company, for services rendered as a sole proprietor while he resided in Texas. Although appellant performed his staffing services in Texas and apparently he was never physically present in California during 2016, there is no statutory requirement that he must have a physical presence in California for the state to impose a tax. (*Appeal of Bindley, supra*, 2019-OTA-179P at p. 5.) Consequently, we conclude that appellant was carrying on his business within and without California. Therefore, this requirement is met and we will next apply Regulation 17951-4(c) to determine how much California source income appellant derived in 2016.

California's Market-Based Sales Factor Sourcing Provisions

Regulation 17951-4(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(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 Cal. Code Regs., tit. 18, § 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 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 that is sourced to 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), 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), provides 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.” (Cal. Code Regs., tit. 18, § 25136-2(b)(1).) Regulation 25136-2(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:

- (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 [i.e., Host Analytics] 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.
- (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.

- (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.
- (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.

Applying the first cascading rule, appellant produced a copy of the agreement between his business and Host Analytics. FTB argues that since the agreement lists Host Analytics's headquarters in Redwood City, California, and the parties entered into the agreement in Los Angeles (based on the agreement's reference to a Los Angeles address), Host Analytics received the benefit of appellant's services in California. However, we find neither the agreement nor appellant's limited books and records identify where the benefit of appellant's services was received. The agreement suggests that appellant is in the business of searching and finding employees for Host Analytics and that appellant is compensated based on a percentage of the first-year base salary of a prospective candidate ultimately hired by Host Analytics. But that agreement does not indicate the location(s) where the hired employees worked for Host Analytics, which would presumably indicate where Host Analytics received the benefit of appellant's services. Therefore, we cannot source appellant's \$28,000 of gross receipts from Host Analytics under this rule.

Applying the second cascading rule, we can reasonably approximate the location where Host Analytics 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 [Host Analytics] to the extent such information is available to [appellant]." (Cal. Code Regs., tit. 18, § 25136-2(b)(7).) It is undisputed that Host Analytics had two other locations, in addition to its headquarters in Redwood City, California: one in Reno, Nevada, and the other in Hyderabad, India. Based on the limited record, and lack of argument by the parties

regarding the application of the second cascading rule, it is reasonable to conclude that Host Analytics received the benefit of appellant's services where Host Analytics had business locations, which is presumably where the hired employees worked.⁷ Therefore, we can reasonably approximate the benefit received in California by using a ratio of Host Analytics's California locations to all of its locations, which produces a ratio of one-third.⁸ Consequently, appellant has a one-third sales factor apportionment percentage.

Accordingly, since appellant's total business income from his unitary business is \$22,108 and he has a sales factor apportionment percentage of one-third, we conclude he generated \$7,369.33 of California source income (or AGI) during 2016. (See Cal. Code Regs., tit. 18, § 17951-4(c)(1), (2).)

Issue 2. Whether appellant has established reasonable cause for failing to timely file a 2016 return.

California imposes a penalty for failing to file a return on or before the due date, unless the taxpayer shows that the failure is due to reasonable cause and not due to willful neglect. (R&TC, § 19131(a).) The late-filing penalty is calculated at 5 percent of the tax for each month or a fraction thereof that the return is late, with a maximum penalty of 25 percent of the tax. (*Ibid.*) 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 such cause existed as would prompt an ordinary intelligent and prudent business[person] to have so acted under similar circumstances." (*Appeal of Tons* (79-SBE-027) 1979 WL 4068.)

When FTB imposes a penalty, the law presumes that the penalty was imposed correctly. (*Appeal of Myers, supra.*) The burden is on the taxpayer to establish reasonable cause for the failure to timely file. (*Appeal of Bieneman* (82-SBE-148) 1982 WL 11825.) To overcome the

⁷ FTB submitted public records from the California Secretary of State showing that Host Analytics is registered and located in California and therefore asserts that under the second cascading rule, the location where the benefit is received can be reasonably approximated to be only in California. However, this evidence is of limited value because it does not disclose non-California location(s), and in any event, it is not as persuasive as the screenshot of Host Analytics's website indicating it has three business locations, only one of which is in California.

⁸ FTB rejects the screenshot of Host Analytics's website because it does not show any connection of appellant's work to the non-California locations and he has not provided any evidence of communication or correspondence with either of those two locations. However, since appellant's agreement with Host Analytics is silent as to where the hired employees will work, which is presumably the location(s) where it received the benefit of appellant's services for purposes of Regulation 25136-2(c), it is reasonable to look to Host Analytics's three business locations to approximate where those employees likely worked.

presumption of correctness attached to the penalty, the taxpayer must provide credible and competent evidence supporting a claim of reasonable cause; otherwise the penalty cannot be abated. (*Appeal of Walshe* (75-SBE-073) 1975 WL 3557.)

Here, FTB did not receive appellant's 2016 return. Appellant has not provided any explanation that would demonstrate reasonable cause for failing to timely file a 2016 return, such as what steps, if any, he took to determine whether he had a filing requirement during the time-period the return became due. As discussed above, appellant had a filing requirement because he had sufficient California source income and met the filing threshold for 2016. Accordingly, appellant has not satisfied his burden of proving that his failure to timely file a return was due to reasonable cause.

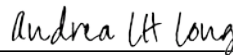
HOLDINGS

1. Appellant derived California source income of \$7,369.33 and therefore he is required to file a 2016 nonresident return.
2. Appellant has not established reasonable cause for failing to timely file a 2016 return.

DISPOSITION

FTB's action is modified to take into account that appellant derived only \$7,369.33 of California source income in 2016. Accordingly, FTB's proposed assessment of tax and the late-filing penalty, plus interest, shall be recomputed accordingly. Otherwise, FTB's action is sustained.

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Andrea L.H. Long

Administrative Law Judge

We concur:

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Kenneth Gast

Administrative Law Judge

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Sara A. Hosey

Administrative Law Judge

Date Issued: 2/20/2020