

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:) OTA Case No. 19044671
R. WEEKS AND)
D. YAU)
_____)

OPINION

Representing the Parties:

For Appellants: R. Weeks and D. Yau

For Respondent: Kim L. Akin, Specialist

For the Office of Tax Appeals: William J. Stafford, Tax Counsel III

E. S. EWING, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, R. Weeks and D. Yau (appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing an assessment of \$203,216 in additional tax, plus applicable interest, for the 2015 tax year.

Appellants waived their right to an oral hearing and therefore the matter is decided based on the written record.

ISSUE

Whether appellants have substantiated their claimed deductions.

FACTUAL FINDINGS

1. Appellants filed a timely joint 2015 California income tax return (Form 540).
2. On an attached Schedule C, appellant-wife reported receiving gross receipts of \$3,025,000 attributable to her sole proprietorship, Oakrinda Joint Venture, LLC (Oakrinda),¹ which derived its gross receipts from the acquisition, remodel, and ultimate sale of a single-family home located in Piedmont, California (Piedmont property).

¹ Notwithstanding the title “Joint Venture” in Oakrinda’s name, the business was a sole proprietorship of appellant-wife.

3. Oakrinda purchased the property in 2013 for \$1,250,000 and later sold the property in 2015 for \$3,025,000.
4. On a Schedule C, appellant-wife reported a net profit from sale of the Piedmont property of just \$31,550 for the 2015 tax year.
5. Subsequently, FTB notified appellants that their 2015 return was under examination and that appellants were required to substantiate various expense and profit amounts.
6. In response, appellants provided copies of documents titled “Buyer’s Estimated Closing Costs” and “Seller’s Final Settlement Statement,” the latter of which listed selling expenses for the Piedmont property of \$179,646.
7. Appellants also provided a copy of a computer-generated transaction report (Transaction Report) dated January 2014, through December 2015, which purports to list purchase expenses for the Piedmont property of \$882,822, in addition to purported subcontractor expenses totaling \$106,535.
8. After reviewing the above-listed information, FTB requested supporting documentation for the Transaction Report items, such as copies of invoices, receipts, cancelled checks, and bank statements.
9. When appellants failed to provide the requested information, FTB issued a Notice of Proposed Assessment (NPA). The NPA adjusted appellant-wife’s gain on the sale of the Piedmont property from \$31,550 to \$1,591,904, a difference of \$1,560,354. The NPA also set forth additional income from disallowed itemized deductions of \$83,346.
10. In response, appellants filed a timely protest, the particulars of which are not located in the appeal record.
11. After reviewing the matter on protest, FTB issued a Notice of Action (NOA), which affirmed the NPA.
12. Appellants then filed this timely appeal.
13. As set forth below, FTB has agreed on appeal to modify the NOA to reflect that appellants have substantiated additional deductions totaling \$160,321.

DISCUSSION

Burden of Proof

Income tax deductions are a matter of legislative grace, and a taxpayer who claims a deduction has the burden of proving by competent evidence that he or she is entitled to that deduction. (See *New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435; *Appeal of Myers* (2001-SBE-001) 2001 WL 37126924.) Unsupported assertions cannot satisfy the taxpayer’s burden of proof. (*Appeal of Magidow* (82-SBE-274) 1982 WL 11930.)

Adjusted Basis

Internal Revenue Code (IRC) section 1001(a) provides that the gain on the sale of property shall be the excess of the amount realized over the adjusted basis provided for in IRC section 1011.² IRC section 1011(a) provides that the adjusted basis for determining the gain from the sale of property shall be the property’s initial basis (determined under IRC section 1012 or other applicable sections of that subchapter) adjusted as provided for in IRC section 1016.

Under IRC section 1016, the property’s initial basis must be adjusted for capital expenses and capital recoveries. Capital expenses increase the initial basis and capital recoveries decrease the initial basis so that on the date of disposition the adjusted basis reflects the unrecovered cost or other basis of the property. (IRC, § 1016(a).) Capital expenses include the cost of capital improvements and betterments made to the property by the taxpayer. (*Ibid.*)

Amounts expensed for ordinary and necessary incidental repairs and maintenance may be deducted by a cash basis taxpayer when paid, while amounts incurred to permanently improve property or to increase its value or useful life must be capitalized and depreciated over the useful life of the improvement. (See *Schroeder v. Commissioner*, T.C. Memo. 1996-336.)

Business Expenses

IRC section 162(a) authorizes a deduction for “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.”³ (*Roberts v. Commissioner*, T.C. Memo. 2012-197.) A trade or business expense is ordinary for purposes of IRC section 162 if it is normal or customary within the particular trade, business, or industry, and

² California conforms to IRC sections 1001 and 1011-1016 pursuant to R&TC section 18031.

³ IRC section 162 is generally incorporated into California law at R&TC sections 17071 and 17201.

is necessary if it is appropriate and helpful for the development of the business. (*Roberts v. Commissioner, supra.*) In contrast, personal, living, or family expenses are generally not deductible. (*Ibid.*)

Analysis

During these proceedings, FTB made numerous requests for appellants to provide additional evidence (e.g., cancelled checks, bank statements, invoices) in relation to the claimed deductions. Indeed, FTB made its requests promptly during the 2016 and 2017 years; and we note that the alleged expenses related to the 2015 tax year. However, as discussed below, appellants have failed to provide additional evidence showing that they are entitled to deductions beyond the \$160,321 that FTB is allowing on appeal.

As for cancelled checks and/or bank statements, other than the deductions totaling \$160,312 that FTB is allowing on appeal, appellants have not provided cancelled checks and/or bank statements supporting further deductions for any items detailed in their Transaction Report for the Piedmont property—or for any other deductions (such as itemized deductions) that were disallowed in the NOA.⁴ Although appellants have provided some check copies (fronts only), the checks do not specifically tie into any of the items in appellants' Transaction Report and, in any event, do not show that related payments cleared the bank.

As for invoices, other than the deductions totaling \$160,321 that FTB is now allowing on appeal, appellants have not provided invoices that specifically tie to or associate the Piedmont property to the Transaction Report or establish that the work and materials set forth in the invoices were associated with the Piedmont property, which was sold in 2015. Further, the invoices do not substantiate any other applicable deductions (such as itemized deductions) that were disallowed in the NOA and that have not been conceded by FTB on appeal.

Finally, in relation to the deductions totaling \$160,321 that FTB is allowing on appeal, we note the following.

⁴ We note that a partial bank statement for an unspecified Wells Fargo checking account was provided for a period spanning just over seven days (apparently for the 2015 tax year), but copies of the few check numbers listed in that partial bank statement were not provided.

Mortgage Interest

In a letter dated April 7, 2018, appellants claim that they are entitled to a mortgage interest deduction of \$328,794, even though appellant-wife originally deducted mortgage interest of just \$280,000 on the Schedule C. FTB denied the deduction in full. Here, appellants have not provided any documentation evidencing interest expense payments of either \$280,000 or \$328,794. Accordingly, FTB properly denied the mortgage interest deduction in full.

Natural Slate Roofing

In a letter dated July 27, 2018, appellants claim they substantiated expenses totaling \$95,410 paid to this subcontractor. The invoice dated June 10, 2014, from Natural Slate Roofing details work performed at the Piedmont property and identifies total charges of \$80,050. The invoice also provides details of payments appellants made, which total \$67,200. On appeal, FTB is allowing an expense amount of \$67,200. We find no error with FTB's allowance. While appellants have added additional payments to this invoice in hand written notes at the bottom of the invoice and provided a check number, appellants have not provided the canceled checks and have not explained why such checks were not provided.

Home Depot

Appellants claim they substantiated expenses totaling \$42,600 paid to Home Depot. FTB states that several receipts from Home Depot were provided.⁵ We do note that the Transaction Report provided by appellants lists ten charges for Home Depot, each in the amount of \$55,262.03, but appellants did not claim these particular expenses on their return. However, FTB asked for substantiation of these charges and appellants provided none. Due to receiving additional documentation, on appeal, FTB is now allowing the expense amount actually claimed by appellants in the amount of \$42,600.

Artistic Geometry

In appellants' letter dated July 27, 2018, appellants claim they substantiated expenses totaling \$30,961.55 paid to this subcontractor. FTB disallowed the deduction in full. We find no error with FTB's disallowance. We note that copies of the checks provided to substantiate this expense were not cancelled checks and do not evidence that any amounts related to this

⁵ We note that such receipts are not located in the appeal record.

subcontractor were actually paid and the checks cleared. Further, checks 2300 and 2213 identify unrelated property (not the Piedmont property) in the memo sections and several checks appear to have been altered.

Economy Lumber

In appellants' letter dated July 27, 2018, appellants claim expenses totaling \$75,108.57 paid to this subcontractor. We further note that the Transaction Report provided by appellants lists five charges for Economy Lumber, each in the amount of \$18,400, but appellants did not claim these particular expenses on their return. However, FTB asked for substantiation of these charges and appellants provided none. The invoices show various delivery and shipping addresses for materials and one invoice evidences returns. After receiving additional documentation on appeal, FTB is now allowing an expense amount of \$50,521.

Pacific Sales

In appellants' letter dated July 27, 2018, appellants claim expenses totaling \$20,408.67 paid for appliances. FTB disallowed the deduction in full. We find no error with FTB's disallowance. We note that an invoice dated June 13, 2014, identifies appliances purchased from Pacific Sales for \$19,645.69 and delivered to the Piedmont property. Appellants, however, did not provide a copy of the canceled check evidencing the payment, but appellants did provide a partial page of a bank statement showing check number 1221 in the amount of \$20,408.67 cleared. However, because no image of the check was provided with the bank statement, we cannot verify the payee on the check. Further, appellants did not explain why they allegedly paid an amount different from the invoice amount, nor did appellants explain why they could not produce the canceled check. Finally, we note that the method of payment stated on the invoice is cash on delivery (COD). The delivery date of half the items was June 24, 2014, but the check cleared on June 18, 2014, which is inconsistent with a COD payment.

Conclusion

In summary, appellants have introduced only minimal records, which taken together, are insufficient to justify deductions beyond the \$160,321 that FTB is allowing on appeal. As noted above, in the absence of corroborating evidence, we are not required to accept appellants' unsupported assertions. (*Appeal of Magidow, supra.*)

HOLDING

The NOA is modified, as conceded by FTB on appeal, such that appellants are allowed additional deductions totaling \$160,321. The NOA is otherwise sustained.

DISPOSITION

The NOA is modified in accordance with the holding above. Otherwise, FTB’s action is sustained.

DocuSigned by:
Elliott Scott Ewing
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Elliott Scott Ewing
Administrative Law Judge

We concur:

DocuSigned by:
Michael F. Geary
149B52EF88AC7
Michael F. Geary
Administrative Law Judge

DocuSigned by:
Amanda Vassigh
7B17E958B7C14AC
Amanda Vassigh
Administrative Law Judge

Date Issued: 3/2/2020