OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18011717
D. NEWTON	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Christopher Engelmann, Tax Appeals Assistance Program (TAAP)[1]
For Respondent:	Brian Werking, Tax Counsel
For Office of Tax Appeals:	Louis Gabriel, Graduate Student Assistant

S. HOSEY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, D. Newton (appellant) appeals an action by Franchise Tax Board (respondent) proposing $4,219 of additional tax, plus applicable interest, for the 2010 tax year.[2]

Office of Tax Appeals Administrative Law Judges: Sara A. Hosey, John O. Johnson, and Kenneth Gast held an oral hearing for this matter in Cerritos, California, on December 19, 2019. At the conclusion of the hearing, the record was closed and this matter was submitted for decision.

ISSUE

Has appellant demonstrated error in respondent's proposed assessment, which is based on federal adjustments?

[1] Appellant filed his own appeal letter. Brad Birchfield of TAAP filed appellant's reply brief, and Noel Garcia of TAAP filed appellant's supplemental and additional briefs.

[2] Respondent concedes that the accuracy-related penalty was erroneously imposed and therefore the penalty will be abated at the conclusion of this appeal.

FACTUAL FINDINGS

1. Appellant operated an automobile wholesaling business in La Mesa, California. Appellant timely filed his 2010 California Resident Income Tax Return (Form 540), reporting California adjusted gross income and itemized deductions, for taxable income of $0.[3] Appellant reported that he had no tax liability. Appellant's federal Schedule C reported gross receipts of $92,687, reduced by a cost of goods sold deduction of $81,525, for a gross profit and gross income of $11,162. The cost of goods sold deduction was computed with reference only to the total annual cost of inventory appellant claimed to have purchased, and the beginning and ending inventory amounts were not reported. Respondent processed the return and accepted it as filed.
2. Subsequently, respondent received information from the Internal Revenue Service (IRS) in the form of a FEDSTAR IRS Data Sheet. As applicable to this appeal, the FEDSTAR IRS Data Sheet indicated that the IRS disallowed all of appellant's Schedule C expenses of $81,525 (i.e., the claimed cost of goods sold deduction). The IRS increased appellant's federal taxable income by $75,766. Additionally, the IRS imposed an accuracy-related penalty of $4,910.80.
3. Based on this information, respondent issued a Notice of Proposed Assessment (NPA) following the IRS's adjustments on September 11, 2015. The NPA allowed a one-half self-employment tax adjustment of $5,759 and disallowed $81,525 in Schedule C expenses (i.e., the cost of goods sold deduction), increasing appellant's taxable income by $75,766. The NPA proposed additional tax of $4,219, plus applicable interest, and imposed an accuracy-related penalty of $843.80.
4. In a letter to respondent dated October 9, 2015, appellant protested the NPA and asserted that his federal return was correct. Appellant explained that the IRS had asked appellant to provide documentation regarding his home loan, and appellant had failed to meet the IRS's deadline date. Appellant also indicated that he had filed for bankruptcy.
5. Appellant received a chapter 7 bankruptcy discharge on October 25, 2016. Accordingly, the IRS discharged all of appellant's federal tax liability on November 21, 2016.

[3] While the sum of these figures results in negative taxable income, a figure less than zero is reported as $0 on the return.

6. On April 3, 2017, respondent issued a Notice of Action affirming the NPA. Appellant timely filed this appeal.

7. During briefing of this appeal, appellant contends that he is entitled to the cost of goods sold deduction as reported. In support, appellant provided one sales contract from his business dated February 25, 2010, for the sale of one vehicle; a Board of Equalization electronic filing report from the 2010 filing period detailing total gross sales of $92,687; and automobile auction invoices dated between January 8, 2010, and October 28, 2010, totaling $23,940 of vehicle purchases. Appellant also provided a news article dated February 7, 2014, that indicates a suspicious fire engulfed an empty building in La Mesa, California that he asserts was where his office was located.[4]

DISCUSSION

R&TC section 18622(a) provides that taxpayers shall either concede the accuracy of a federal determination or state wherein it is erroneous. A deficiency assessment based on a federal audit report is presumptively correct and taxpayers bear the burden of proving that the 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 insufficient to satisfy taxpayers' burden of proof with respect to an assessment based on a federal action. (*Appeal of Magidow* (82-SBE-274) 1982 WL 11930.) The taxpayers' failure to produce evidence that is within their control gives rise to a presumption that such evidence is unfavorable to their case. (*Appeal of Cookston* (83-SBE-048) 1983 WL 15434.)

Further, taxpayers bear the burden of substantiating the amount claimed as cost of goods sold and it is their responsibility to maintain adequate books and records sufficient to substantiate all of the items on the tax return, including cost of goods sold. (*Jackson v. Commissioner*, T.C. Memo. 2008-70; *Rodriguez v. Commissioner*, T.C. Memo. 2009-22; Internal Revenue Code (IRC), § 6001.)

The evidence in the record shows that the IRS concluded its examination of the appellant's 2010 tax return without making any adjustments to the determination on which respondent based its assessment. Although the federal transcript shows that the IRS ultimately released its liens against appellant, this was because of appellant's chapter 7 bankruptcy

[4] As discussed below, appellant claims he is unable to obtain all the evidence necessary to support his expenses because he lost all records in a building fire.

discharge and not due to a change in the merits of the IRS's assessment. Therefore, in order to prevail, appellant must show that respondent erred in following the federal determination disallowing Schedule C expenses.

Appellant contends that respondent incorrectly disallowed the claimed cost of goods sold deduction in determining his taxable income. Gross income is defined in IRC section 61(a) to include "gross income derived from business." A manufacturing or merchandising business calculates gross income by subtracting cost of goods sold from gross receipts and adding investment income and proceeds from ancillary operations or sources. (*Kazhukauskas v. Commissioner*, T.C. Memo. 2012-191.) Cost of goods sold is a deduction to gross income and is computed with proper adjustments for opening and closing inventories. (Treas. Regs. §§ 1.61-3(a) & 1.162-1(a).) Cost of goods sold is the amount that the taxpayer expended to purchase or construct the inventory sold during the year. (*Mileham v. Commissioner*, T.C. Memo. 2017-168; *Sawyer v. Commissioner*, T.C. Memo. 2015-55.)

Appellant explains that he was unable to obtain the evidence necessary to support his return because he lost all records in a building fire.[5] Appellant asserts that the record indicates he clearly incurred an offset to gross income, such that the offset may be estimated pursuant to the holding for unproven expenses under the rule in *Cohan v. Commissioner* (2d Cir. 1930) 39 F.2d 540 (*Cohan*). The *Cohan* rule was adopted when the famous theatrical producer George M. Cohan testified at trial that he had spent substantial sums of money on travel and entertaining actors, employees, and drama critics in furtherance of his theatrical production business. Mr. Cohan could not substantiate by records his actual expenditures but instead estimated the amounts in his testimony. The court held that, where a taxpayer has established that he or she has incurred an expense for which a deduction may properly be claimed but is unable to document the exact amount of the expense, a court may make a reasonable estimate of the deduction in certain circumstances, "bearing heavily" against the taxpayer whose inexactitude is of his or her own making.[6] (*Id.* at pp. 543-44.)

[5] However, the fire described in the news article appellant has submitted took place in a vacant building without electricity or gas.

[6] Although the sums at issue in *Cohan* were deductions and not expenses, the *Cohan* rule has also been applied to cost of goods sold. (*Gaitan v. Commissioner* T.C. Memo. 2012-3; *Jabari v. Commissioner* T.C. Memo. 2017-238.)

For a court to estimate the amount of expenses under the *Cohan* rule, it must have some basis upon which an estimate may be made. (*Becker v. Commissioner* T.C. Memo. 2018- 69, 34.) Without such a basis, any allowance would amount to unguided generosity. (*Williams v. United States* (5th Cir.1957) 245 F.2d 559, 560-561.) A court may estimate some expenses, but only if the taxpayer provides at least some evidence to support an estimate, and the court is convinced that he or she incurred them. (*Cohan, supra*, 39 F.2d at pp. 543-44.)

In this instance, the IRS denied appellant's cost of goods sold deduction and appellant has not supplied sufficient evidence regarding the cost of goods sold for this tax year. Appellant's Board of Equalization electronic filing report confirms that his gross sales during the 2010 tax year totaled $92,687, but the report does not provide any basis upon which to estimate the cost of goods sold. The sales contract appellant has produced indicates that he sold a black Saab 900 for a total of $1,055 on February 25, 2010, and the invoices appellant has provided indicate that he purchased 14 vehicles in 2010 for a total of $23,940.[7] However, the sales contract does not show the cost of the car that was sold or provide a basis on which its cost may be estimated. Moreover, providing one sales contract does not allow us to estimate the total costs of acquiring the cars he sold in 2010. Appellant has also failed to establish that any of the 14 vehicles he purchased in 2010 were sold during the same year.

Appellant argues that "it would have been impossible . . . to operate his business and generate $92,687 in gross receipts during [the] 2010 tax year" without having purchased any inventory. This may be so, but the fact remains that appellant has failed to produce any basis upon which the cost of the goods sold in 2010 may be estimated. Because appellant has not established that he has incurred expenses in 2010 to properly claim a reduction against 2010 gross receipts, to apply the *Cohan* rule in this case would amount to unguided generosity. (*Williams, supra*, 245 F.2d at pp. 560-561; *Jackson, supra*.) Appellant also argues that the *Cohan* rule should apply to the base of cost of goods sold on the 10-20 percent standard markup appellant testified to at hearing. However, appellant provided no corroborating evidence that his markup was in fact 10-20 percent and, therefore, we have no basis upon which an estimate may be made to apply the *Cohan* rule. Accordingly, appellant has not provided sufficient evidence to establish that respondent erred in its assessment, which is based on federal adjustments.

[7] The invoices produced by appellant do not show that the Saab 900 was purchased during 2010.

HOLDING

Appellant has failed to demonstrate error in respondent's proposed assessment, which is based on federal adjustments.

DISPOSITION

Respondent's action in imposing the accuracy-related penalty is reversed, as conceded by respondent on appeal. Respondent's action is otherwise sustained.

DocuSigned by:
Sara A Hosey
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Sara A. Hosey
Administrative Law Judge

We concur:

DocuSigned by:
John O Johnson
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John O. Johnson
Administrative Law Judge

DocuSigned by:
Kenneth Gast
FD75A3136CB34C2...
Kenneth Gast
Administrative Law Judge

Date Issued: 3/19/2020