OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 19034389
J. VAN CANEGHEM	)
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	)
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	)

OPINION

Representing the Parties:

For Appellant: Ronald S. Litvak, CPA

For Respondent: Jason Riley, Tax Counsel IV

For Office of Tax Appeals: Matthew D. Miller, Tax Counsel III

T. STANLEY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, J. Van Caneghem (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing $329,970 of additional tax, an accuracy-related penalty of $65,994, and applicable interest, for the 2011 tax year.

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

ISSUES

1. Has appellant established error in FTB's determination of the cost basis of shares of stock sold in the 2011 taxable year?
2. Has appellant established that the accuracy-related penalty should be abated?

FACTUAL FINDINGS

1. On January 9, 2006, appellant cofounded Trion World Network, Inc. (TWNI), a video game developer and publisher, as President and Chief Creative Officer.
2. On January 9, 2006, appellant and TWNI executed a Founder Stock Purchase Agreement whereby appellant purchased 8,000,000 shares of TWNI common stock at its par value purchase price of $0.001 per share, or an aggregate purchase price of $8,000. The

agreement provided that 25 percent of the stock (2,000,000 shares) vested on January 9, 2006. The remaining 75 percent of the stock (6,000,000 shares) vested over a period of three years from January 9, 2006, at a rate of 1/36 per month so long as appellant provided services to TWNI as an employee or consultant.

3. Appellant signed and filed with the Internal Revenue Service, an election under Internal Revenue Code (IRC) section 83(b)[1] in which he reported the fair market value of his January 9, 2006 purchase of 8,000,000 shares of TWNI common stock as $8,000.

4. Appellant and TWNI executed a Bill of Sale and Assignment Agreement wherein appellant agreed to sell to TWNI all "rights, title, and interest in and to the designs, concepts, code, algorithms and other innovations that relate to [TWNI's] platform and all documentation and records relating thereto, in each case that were created by or contributed to by [appellant] during the period from June 1, 2005 to January 8, 2006." This included all proprietary rights, including "patents, patent applications, patentable subject matter, copyrights and trade secrets." The consideration for the sale was TWNI's offer of employment in the February 6, 2006 employment agreement.

5. Appellant and TWNI executed an Employee Nondisclosure and Assignment Agreement. Appellant agreed to assign to TWNI all rights, title, and interest in any innovations developed while employed at TWNI with use of TWNI time and resources.

6. On March 17, 2006, appellant and TWNI executed a First Amendment to Founder Stock Purchase Agreement. In relevant part, the amendment changed the vesting period of appellant's 6,000,000 unvested shares as of January 9, 2006, to four years at a rate of 1/48 per month.

7. Appellant and TWNI executed a First Amendment to the Employment Agreement. In relevant part, the amendment added a term providing for a potential "special cash bonus" sixth months following the commercialization of TWNI's first product or service. The

[1] Under IRC section 83, restricted stock granted in connection with the performance of services generally becomes taxable as ordinary income compensation when it is no longer subject to a substantial risk of forfeiture and is freely transferable. IRC section 83(b) and Treasury Regulation section 1.83-2(a) permit a taxpayer who has received compensatory restricted stock or other property subject to a substantial risk of forfeiture to make a special election to include in gross income in the year of receipt, any excess of the fair market value of the property at the time of transfer over the amount (if any) paid for the property. Making such an election "closes" the compensation element of the grant, and therefore, future vesting would not be taxable, and future sales or transfer generally would generate capital gains and not ordinary income.

amount of the bonus was to be determined by TWNI's board and would depend on the success of such initial product or service and the financial health of TWNI at such time.

8. On August 22, 2008, TWNI executed and filed an Amended and Restated Certificate of Incorporation with the State of Delaware whereby TWNI authorized the issuance of 85,000,000 shares of common stock and 53,549,978 shares of preferred stock, both with par values of $0.001 per share. TWNI designated three series of preferred stock: (1) 15,941,698 shares of Series A preferred stock with an original issuance price of $0.4391; (2) 19,108,280 shares of Series B preferred stock with an original issuance price of $1.57; and (3) 18,500,000 shares of Series C preferred stock with an original issuance price of $5.49107.

9. On May 11, 2009, appellant and TWNI executed a Separation Agreement and General Release whereby TWNI terminated appellant's employment contract. The agreement provided that, as of the date of termination, appellant was vested in 7,312,500 shares of TWNI common stock out of the 8,000,000 shares purchased on January 9, 2006. The remaining 687,500 shares were unvested and were subject to repurchase at TWNI's discretion. The agreement also provided for six months of severance pay and reimbursement of reasonable business expenses, and it provided that TWNI had no obligation to appellant for any other compensation of any kind.

10. Appellant retained a law firm to sell his shares of TWNI common stock. On May 19, 2011, appellant sold 1,828,125 shares of TWNI common stock for $1,906,478.44. On May 25, 2011, appellant sold an additional 1,828,125 shares of TWNI common stock for $1,906,475.45. On June 9, 2011, appellant sold his remaining 3,656,250 vested shares of TWNI common stock for $3,812,956.88.

11. Appellant timely filed his 2011 California tax return and reported $140,401 of tax. On federal Schedule D, "Capital Gains and Losses," appellant reported the sales price of his

shares of TWNI common stock as $7,625,914[2], a basis of $6,369,480, and capital gain of $1,256,434.[3]

12. FTB audited appellant's tax returns for tax years 2009, 2010, and 2011.[4] At audit, appellant claimed he calculated the adjusted basis of the stock based on a per-share acquisition price of $0.4391 plus $3,158,577 in brokerage and attorney's fees.

13. FTB accepted the brokerage and attorney's fees as properly included in the adjusted basis, but it determined that appellant's cost-per-share acquisition price was $0.001. Therefore, FTB determined that appellant underreported the cost basis in TWNI common stock by $3,203,590.

14. On March 22, 2016, FTB issued appellant a Notice of Proposed Assessment (NPA) for the 2011 tax year, proposing additional tax of $329,970, and an accuracy-related penalty of $65,994, plus interest. Appellant timely protested the NPA.

15. On December 28, 2018, FTB issued a Notice of Action affirming the NPA. This timely appeal followed.

DISCUSSION

Issue 1: Has appellant established error in FTB's determination of the cost basis of shares of stock sold in the 2011 taxable year?

FTB's assessment is presumed correct, and a taxpayer has the burden of proving it to be wrong. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514.) Unsupported assertions do not satisfy an appellant's burden of proof. (*Appeal of GEF Operating, Inc.*, 2020-OTA-198P; see also *Appeal of Stabile*, 2020-OTA-198P.) In the absence of uncontradicted, credible, competent, and relevant evidence showing that FTB's determination is incorrect, it must be upheld. (*Appeal of Xie*, 2018-OTA-76P.)

[2] Based on the documents in the record, the sales price totals $7,625,910.77 (i.e., $1,906,478.44 + $1,906,475.45 + $3,812,956.88). Appellant reported the sales price as $7,624,914 (a nominal difference of $3.23), and FTB used appellant's reported numbers in its briefing and calculations. Accordingly, we address the sales price as reported by both parties.

[3] On federal Form 8949, "Sales and Dispositions of Capital Assets," appellant described the TWNI common stock as "Morgan Keegan Technology," the name of the broker that sold the stock on appellant's behalf.

[4] Only taxable year 2011 is at issue in this appeal.

IRC section 1001(c) provides that the entire amount of gain or loss on the sale or exchange of property is recognized unless otherwise provided. 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 as defined in IRC section 1011, and the loss shall be the excess of the adjusted basis over the amount realized. 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 with adjustments provided in IRC section 1016. The basis of property shall be the cost of such property, except as otherwise provided in IRC section 1016(a)(1)(A), which allows for an increase to the cost basis for capital expenditures, including the costs of improvements and betterments to property.[5] (Treas. Reg. § 1.1016-2(a).)

Income tax deductions are a matter of legislative grace, and a taxpayer who claims a deduction has the burden to prove by competent evidence that he or she is entitled to take that deduction. (See *New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435; *Appeal of Dandridge*, 2019-OTA-458P.) A taxpayer also bears the burden to prove basis for the purpose of calculating gain or loss on the sale of underlying property. (*Fargo v. Commissioner*, T.C. Memo. 2015-96; *Marcus v. Commissioner*, T.C. Memo. 1996-190.) The taxpayer must establish the cost or adjusted basis for property sold because recovery of an amount in excess of costs constitutes income. (*Wheeler v. Commissioner*, T.C. Memo. 2014-204.) In certain circumstances, we may use the *Cohan* rule (see *Cohan v. Commissioner* (2d Cir. 1930) 39 F.2d 540) to estimate a taxpayer's basis in an asset at the time of transfer, but the taxpayer must provide some reasonable, *evidentiary* basis for the estimate. (*Wheeler*, *supra*, T.C. Memo. 2014-204, at *p.7; *Polyak v. Comm*issioner, 94 T.C. 337, 345–346.) The *Cohan* rule cannot substitute for the taxpayer's burden of proof. (See *Coloman v. Commissioner* (9th Cir. 1976) 540 F.2d 427, 431–32.)

Here, appellant contends that while employed at TWNI, he developed intellectual property that benefited the company, the development of which increased the basis in appellant's shares of common stock. Appellant appears to allege that such intellectual property increased the stock price to the original issuance price of the Series A preferred stock issued by TWNI (i.e., $0.4391 per share.) Appellant further contends that he made numerous attempts to contact TWNI to obtain the documentation necessary to substantiate the claimed adjusted basis;

[5] California conforms to IRC sections 1001 and 1011-1016 at R&TC section 18031.

however, due to a recent transaction, TWNI no longer exists, and any hope of obtaining the relevant documentation has been eliminated. Therefore, appellant relies on the *Cohan* rule to estimate the adjusted basis. Appellant does not identify the intellectual property he purportedly developed while an employee at TWNI, nor does he identify or describe any agreement between him and TWNI that provided for an increase to the basis of the shares of common stock. Additionally, appellant has not provided supporting documentary or testamentary evidence to support those contentions, such as written agreements or declarations of any witnesses, including himself.

A taxpayer who claims a deduction must keep sufficient records to substantiate the claimed deduction. (*Sparkman v. Commissioner* (9th Cir. 2007) 509 F.3d 1149, 1159; see Cal. Code Regs., tit. 18, § 19032(a)(5).) The fact that it may be difficult, if not impossible, for the taxpayer to substantiate a claimed deduction does not relieve them of this burden. (*Burnet v. Houston* (1931) 283 U.S. 223, 228.) Even the *Cohan* rule requires the taxpayer to provide some reasonable evidentiary basis for the estimate. (*Wheeler*, *supra*, T.C. Memo. 2014-204, at *p.7.) Here, appellant provides no evidence to support the estimate that the common stock basis is equal to the issuance price for Class A preferred stock; in fact, appellant provides no evidence at all. Rather, all evidence in the record is provided by FTB and supports its determination.

The Founder Stock Purchase Agreement indicates that appellant purchased 8,000,000 shares of TWNI common stock at its par value purchase price of $0.001 per share, or an aggregate price of $8,000. The $0.001 purchase price is supported by the Amended and Restated Certificate of Incorporation and appellant's IRC section 83(b) election. The Bill of Sale and Assignment Agreement indicates appellant agreed to sell and assign to TWNI all rights, title, and interest in and to the designs, concepts, code, algorithms and other innovations that relate to TWNI's platform and all documentation and records developed prior to his employment in consideration for TWNI's offer of employment. The employment contract indicates that in consideration for appellant's employment with TWNI, he received a salary, the vesting of his common stock, and the potential for a cash bonus six months following the commercialization of TWNI's first product or service. Finally, the Employee Nondisclosure and Assignment Agreement provides for the assignment to TWNI of all rights, title, and interest in any innovations developed by appellant while employed at TWNI with use of TWNI time and resources. The evidence does not support appellant's assertion that the development of

intellectual property that benefited TWNI increased appellant's basis in his TWNI common stock. To the contrary, the evidence establishes that appellant received compensation as an employee (including the vesting of his common stock and a potential cash bonus) in exchange for his services as an employee of TWNI, including services that resulted in the development of intellectual property that benefited TWNI.

The May 11, 2009 Separation Agreement and General Release provided that as of the date of termination, appellant was vested in 7,312,500 shares of TWNI common stock purchased on January 9, 2006. Appellant sold all 7,312,500 shares in 2011 and reported proceeds totaling $7,625,914. FTB accepted appellant's claimed brokerage and attorney's fees of $3,158,577 as properly included in the adjusted basis, but it determined that appellant's cost-per-share acquisition price was $0.001 (i.e., $0.001 × 7,312,500 = $7,312.50.) Therefore, FTB determined that appellant underreported his cost basis in TWNI common stock by $3,203,590. All evidence in the record supports FTB's determination. Appellant has failed to present any evidence in support of his contention that the price per share was $0.4391; thus, he has not met his burden to show error in FTB's determination.

Issue 2: Has appellant established that the accuracy-related penalty should be abated?

R&TC section 19164, which generally incorporates the provisions of IRC section 6662, provides for an accuracy-related penalty of 20 percent of the applicable underpayment of tax. As relevant here, the penalty applies to the portion of the underpayment attributable to: (1) negligence or disregard of rules and regulations, or (2) any substantial understatement of income tax. (IRC, § 6662(b).) For an individual, there is a "substantial understatement of income tax" when the amount of the understatement for a taxable year exceeds the greater of 10 percent of the tax required to be shown on the return, or $5,000. (IRC, § 6662(d)(1)(A).) In determining whether there is a substantial understatement, the taxpayer excludes any portion of the understatement for which: (1) there is substantial authority for the treatment of the position, or (2) the position was adequately disclosed in the tax return (or a statement attached to the return) and there is a reasonable basis for the treatment of the item. (IRC, § 6662(d)(2)(B).) Appellant reported $140,401 of tax on his return. The proposed addition of tax of $329,970 is greater than 10 percent of the correct tax (i.e., $470,371 x 0.10 = $47,037) and $5,000; therefore, there is a substantial understatement. Appellant has not alleged nor shown that either of the exceptions apply.

Even if an understatement is found to be substantial, the penalty shall not be imposed to the extent the taxpayer can show reasonable cause and good faith. (R&TC, § 19164(d); IRC, § 6664(c)(1).) Such a determination is made on a case-by-case basis, considering all the pertinent facts and circumstances. (Treas. Reg. § 1.6664-4(b)(1).) Relevant factors may include the taxpayer's efforts to assess the proper tax liability, including the taxpayer's reasonable and good faith reliance on the advice of a qualified tax professional. (*Ibid.*) Appellant contends that he relied on the professional opinion of his certified public accountant (CPA) to accurately comply with the law based on the information available. To prove reasonable reliance on a qualified tax professional, the taxpayer must meet each requirement of the following three-pronged test: (1) the adviser was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer provided necessary and accurate information to the adviser, and (3) the taxpayer actually relied in good faith on the adviser's judgment. (*DeCleene v. Commissioner* (2000) 115 T.C. 457, 477.) Appellant provides no documentary or testimonial evidence to corroborate what tax advice, if any, he received from the CPA, or that he provided necessary and accurate information to the CPA. Therefore, appellant has failed to establish reasonable reliance on a tax professional. Accordingly, we find no basis to abate the accuracy-related penalty.

HOLDINGS

1. Appellant failed to establish error in FTB's determination of the cost basis of shares of stock sold in the 2011 tax year.
2. Appellant failed to establish that the accuracy-related penalty should be abated.

DISPOSITION

FTB's action is sustained.

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Teresa A. Stanley
Administrative Law Judge

We concur:

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Cheryl L. Akin
Administrative Law Judge

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Sheriene Anne Ridenour
Administrative Law Judge

Date Issued: 10/21/2020