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OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **Y. SMITH**	) OTA Case No. 19064937

OPINION

Representing the Parties:

For Appellant: Tax Appeals Assistance Program (TAAP)[1]

For Respondent: Bradley J. Coutinho, Tax Counsel III

For Office of Tax Appeals: Andrew Jacobson, Tax Counsel III

T. STANLEY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, Y. Smith (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing an additional tax of $1,156, plus interest, for the 2014 tax year.

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

ISSUE

Has appellant shown error in FTB's proposed assessment, which is based on a federal adjustment by the Internal Revenue Service (IRS) disallowing appellant's claimed, unreimbursed business expense deductions?

FACTUAL FINDINGS

1. Appellant filed a timely 2014 California Resident Income Tax Return (Form 540), which listed an address on South Western Avenue, Los Angeles, California 90047 (Western Avenue Address). FTB accepted the return as filed and issued appellant a refund of $3.

[1] Appellant filed the opening brief. Vincent Garrido of TAAP submitted appellant's reply brief.

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2. The IRS examined appellant's tax return and made adjustments that increased appellant's income and assessed additional tax. The adjustments were not modified or cancelled, and appellant paid the additional federal tax. The IRS closed its examination on April 17, 2017.
3. On July 25, 2018, FTB issued a Notice of Proposed Assessment (NPA), which stated that FTB adjusted appellant's 2014 return based on information provided by the IRS. The NPA increased appellant's taxable income by $22,163, which consisted of: (1) a disallowed Schedule C-rent/lease other property deduction of $4,500; (2) a disallowed Schedule C-car and truck expenses deduction of $5,920; (3) a disallowed Schedule C-other expenses deduction of $10,500; and (4) unreported gambling winnings of $1,243.[2] As a result of these adjustments, FTB proposed an additional tax of $1,156, plus interest.
4. Appellant protested the NPA and provided a summary statement entitled "2014 Tax Justifications" that summarized appellant's claimed 2014 Schedule C expenses, including: (1) 25,000 business miles, (2) rent, (3) internet, (4) electrical, (5) mobile telephone, (6) advertising, (7) paper and ink; 8) automobile repairs (a new transmission), (9) automobile tune-ups, (10) five oil changes, and (11) an engine oil leak.
5. FTB issued a Notice of Action affirming its NPA.
6. This timely appeal followed. On appeal, appellant re-submitted the summary statement submitted at protest, but provided no supporting documents.
7. On appeal, appellant claims business meal expenses of $2,872, paper expenses of $119 (rounded), and miscellaneous printer ink expenses of $437, even though appellant previously claimed travel, meals, and entertainment expenses of $900 on the original Schedule C.[3]

DISCUSSION

R&TC section 18622(a) provides that a taxpayer shall either concede the accuracy of a federal determination or state wherein it is erroneous. It is well-settled law that a deficiency determination 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

[2] At protest and on appeal, appellant has not addressed FTB's inclusion of gambling winnings of $1,243 in appellant's taxable income. Therefore, we do not address the issue of that income adjustment.

[3] The NPA did not disallow any miscellaneous office expenses claimed on appellant's Schedule C.

Cal.App.2d 509, 514; *Appeal of Vardell*, 2020-OTA-190P.) When a proposed FTB assessment is based on a final federal adjustment, a taxpayer can satisfy the burden of proof in one of two ways: (1) show that the IRS has changed or eliminated its adjustments; or (2) produce evidence that the IRS's or FTB's adjustments are incorrect or inapplicable. If the IRS does reconsider and change its audit determination for the year at issue, the law permits the taxpayer to notify FTB at the time of the federal changes and request that FTB make corresponding state changes. (See R&TC, §§ 18622, 19311.)

The evidence in the appeal record shows that the IRS concluded its examination of appellant's 2014 tax return without making any adjustments to the determination on which FTB based its assessment. According to appellant's 2014 federal account transcript, the IRS examined appellant's 2014 federal return, assessed additional tax, and closed its examination of appellant's return on April 17, 2017. Therefore, based on the evidence in the appeal record, we find that the IRS has neither cancelled nor revised its assessment.

However, while FTB follows federal adjustments to the extent allowable by law, a federal action does not necessarily bind FTB to follow adjustments it believes to be erroneous. (*Appeal of Der Wienerschnitzel Internat., Inc.* (79-SBE-063) 1979 WL 4104.) Therefore, we next examine whether appellant has shown that FTB's adjustments are incorrect or inapplicable.

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. (*New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435, 440.) To sustain his or her burden of proof, a taxpayer must be able to point to an applicable deduction statute and show that he or she came within its terms. (*Appeal of Dandridge*, 2019-OTA-458P.) Unsupported assertions cannot satisfy a taxpayer's burden of proof. (*Ibid.*)

A taxpayer may deduct unreimbursed employee expenses as ordinary and necessary business expenses under R&TC section 17201, which incorporates by reference Internal Revenue Code (IRC) section 162. 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 . . . ." (See also *Roberts v. Commissioner*, T.C. Memo. 2012-197 (*Roberts*).) By contrast, personal, living, or family expenses are generally nondeductible. (IRC, § 262(a).) The expenses must be both ordinary and necessary business expenditures directly related to the taxpayer's trade or business. (*Deputy v. du Pont* (1940) 308 U.S. 488, 497; Treas. Reg. § 1.162-

1(a).) A taxpayer has the burden of showing that a particular expense is not a personal, living, or family expense. (*Heineman v. Commissioner* (1984) 82 T.C. 538, 542.) A taxpayer is required to keep books and records sufficient to establish matters reported on a return. (*Higbee v. Commissioner* (2001) 116 T.C. 438, 440.)

R&TC section 17201 also incorporates IRC section 274(d). The version of IRC section 274(d) in effect for California personal income tax purposes for the 2014 taxable year prohibited an IRC section 162 deduction for the following types of expenses, unless they were substantiated by adequate records or sufficient corroborating evidence: (1) any travel expense, including meals and lodging away from home; (2) any item with respect to an activity in the nature of entertainment, amusement, or recreation; (3) an expense for gifts; or (4) the use of "listed property," as defined in IRC section 280F(d)(4), which includes passenger vehicles. (See also *Roberts*, *supra*.) For vehicle and entertainment deductions subject to heightened substantiation rules, the application of the *Cohan* rule (*Cohan v. Commissioner* (2d Cir. 1930) 39 F.2d 540), discussed below, is expressly superseded. (Treas. Reg. § 1.274-5T(a).)

Vehicle Mileage and Expenses

IRC section 274(d) requires a taxpayer to substantiate expenses by adequate records or other corroborating evidence of: (1) the amount of each use (here, the mileage); (2) the time and place of the use; and (3) the business purpose of the use. Listed property expenditures include "the cost of acquisition, the cost of capital improvements, lease payments, the cost of maintenance and repairs, or other expenditures . . . ." (Treas. Reg. § 1.274-5T(b)(6)(i)(A).) The U.S. Tax Court explains that, "[g]enerally, expenses subject to the strict substantiation requirements of [IRC] section 274(d) must be disallowed in full unless the taxpayer satisfies every element of those requirements." (*Fleming v. Commissioner*, T.C. Memo. 2010-60, at *p.2.) Taxpayers will have maintained "adequate records" if they maintain a log or diary, combined with supporting documents, which substantiate the required elements of the expense, such as the amount, date, and business purpose of the item. (Treas. Reg. § 1.274-5T(c)(2)(i).)

For listed property such as a vehicle, the record must contain sufficient information as to each element of every business/investment use in order to constitute "an adequate record (within the meaning of section 274(d)) . . . ." (Treas. Reg. § 1.274-5T(c)(2)(ii)(C)(1).) With the exception of certain documents created on computers, an adequate record must be in writing. (Treas. Reg. § 1.274-5T(c)(2)(ii)(C)(2).) In general, "the taxpayer may establish the date of each

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trip with a receipt, record of delivery, or other documentary evidence." (Treas. Reg. § 1.274-5T(c)(2)(ii)(C)(1).) "However, the level of detail required in an adequate record to substantiate business/investment use may vary depending upon the facts and circumstances." (*Ibid.*) A taxpayer may choose to deduct actual business-related vehicle expenses or to use the optional standard mileage rate. (Treas. Reg. § 1.274-5(j)(2).) Whether a taxpayer chooses to use actual vehicle expenses or the optional standard mileage rate, "[t]he taxpayer will not be relieved of the requirement to substantiate the amount of each business use (i.e., the business mileage), or the time and business purpose of each use." (*Ibid.*)[4]

Appellant did not list any personal or commuting miles on the Schedule C, yet appellant certified that the vehicle was available for personal use during off-duty hours and that appellant did not have another vehicle that was used for personal use. Therefore, based on appellant's own reporting, the vehicle for which deductions were claimed was, at least in part, a personal vehicle. (See *Michaels v. Commissioner* (1969) 53 T.C. 260, 275 (*Michaels*).) Appellant did not provide a log, which means that appellant must support the claimed mileage with other documentary evidence such as receipts, odometer readings, emails and so forth. (Treas. Reg. § 1.274-5T(c)(2)(ii)(C)(1).) In her summary statement and appeal letters, appellant listed mileage for three daily round trips to and from Los Angeles (90047) and Inglewood (90301). Appellant listed the Western Avenue Address, which is located in zip code 90047, as appellant's address on the 2014 return, as well as the business address listed on appellant's Schedule C.

Appellant's summary statement does not include the actual dates of travel (just a number of days), the locations (other than zip codes), or the business purpose for the travel. The summary statement also does not show a business purpose for appellant's daily travels back to zip code 90047 in between each of appellant's trips to Inglewood. Appellant also has not differentiated between business-related mileage and any nondeductible commuting miles. (See Treas. Reg. § 1.262-1(b)(5).) Moreover, appellant has not supported the summary statement with any contemporaneous documentation as required by IRC section 274(d), which requires a taxpayer to substantiate the time, place, and business purpose of the use.

Likewise, appellant's listed mileage expenses for eight roundtrips from zip code 90047 to the Superior Court Clerk's Office (90012) is not supported by documentary evidence showing

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[4] Appellant improperly claimed both actual expenses and standard mileage on appellant's return. It is not clear from this record which of these expenses were disallowed by the IRS and FTB ($5,920 disallowed out of $14,000 claimed).

the starting and ending points for the trips, nor the business purpose for the travel. Therefore, we find that appellant's claimed expenses in excess of the allowed amount are not substantiated under the heightened requirements of IRC section 274(d).

Vehicle Lease or Rent

Appellant claimed rent or lease of vehicles, machinery, or equipment expenses of $4,500 on the Schedule C, all of which was disallowed by the IRS and FTB. On the Schedule C and in the appeal briefing, appellant has not stated that she leased any other vehicles, machinery, or equipment, other than the vehicle for which mileage was claimed. Appellant also certified on the Schedule C that she had only one vehicle available for both business and personal use. Therefore, based on appellant's own reporting and arguments on appeal, we find that the claimed expenses of $4,500 and the vehicle repair expenses listed in appellant's opening brief are for the same vehicle for which she claimed car and truck expenses of $14,000. A taxpayer may either claim vehicle mileage for travel excluding most commuting expenses, or else may claim actual expenses for vehicle materials and supplies used in maintaining the vehicle, and depreciate the vehicle to the extent of its pro rata use for business purposes, but not both in the same tax year. (See IRC, § 167(a); Treas. Reg. §§ 1.162-3(a)(1), 1.274-5(j)(2).) Here, appellant has not claimed depreciation on the vehicle, but otherwise treats the vehicle as a capital asset used in a trade or business. Even if we were to accept the claimed vehicle expenses in place of the claimed mileage expenses, appellant has still failed to document the alleged pro rata business use of the vehicle and, therefore, this claimed deduction likewise fails pursuant to IRC section 274(d). (See also *Vaksman v. Commissioner*, T.C. Memo. 2001-165 [taxpayer must show which portion of an asset was used exclusively for business].) Finally, FTB has already allowed appellant Schedule C car and truck expenses of $8,080, and appellant may not claim any duplicative deductions.

Therefore, appellant has failed to satisfy the heightened requirements of IRC section 274(d) to substantiate the claimed vehicle expenses of $4,500, and FTB properly disallowed these Schedule C deductions in reliance on the federal determination.

Business Meal Expenses

Fifty percent of unreimbursed business meal expenses are deductible when incurred if directly connected with a taxpayer's trade or business. (IRC, § 274(a).) As in effect during 2014, IRC section 274(d) prohibited the deduction of expenses related to business meals unless

the taxpayer can substantiate the following with sufficient evidence: (1) the amount; (2) the time and place; (3) the business purpose; and (4) the business relationship to the taxpayer of the person receiving the benefit.

Appellant did not claim any deductible meals or entertainment expenses on line 24b of the Schedule C. On appeal, appellant claims meal expenses of $2,872 based on "food for showings" on 359 days at $8 per meal. Appellant must document the claimed business meal expenses pursuant to the heightened requirements of IRC section 274(d), which does not allow for estimation. Appellant has provided no receipts, invoices, or other documents in support of the claimed business meal expenses, nor has appellant stated the business purpose of the claimed business meals and the business relationship with the persons receiving the benefits. (IRC, § 274(d).) Therefore, appellant has failed to satisfy the heightened requirements of IRC section 274(d) for the claimed business meal expenses.

Other Business Expenses

As previously noted, 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 . . . ." Taxpayers must keep books and records sufficient to establish the amounts of claimed deductions. (*Higbee v. Commissioner*, *supra*, 116 T.C. at p. 440.)

On the Schedule C, appellant claimed other expenses of $10,500 for a property unit rental, which were entirely disallowed by the IRS and FTB. On appeal, appellant contends that the expenses were comprised of monthly rent payments of $875. Although appellant did not claim any office supplies expenses on the Schedule C, on appeal, appellant claims miscellaneous expenses for paper and ink.[5]

Appellant has failed to explain for what business purpose she needed to rent space as an onsite property manager at several properties. Appellant added a note to the appeal letter, which stated "see receipts" for appellant's claimed rental expenses. However, appellant has provided no documentation such as receipts, invoices, cancelled checks, business bank statements, or personal statements showing that these expenses were related to the conduct of a trade or business. Indeed, appellant concedes that she "lacks adequate records." Without more evidence

[5] Appellant's summary statement submitted on appeal includes office expenses that were not disallowed by the IRS and FTB. In addition, appellant asserts in the summary statement that appellant had additional expenses for paper and printer ink.

of the nature of appellant's property management business, we cannot determine whether the rented property was used exclusively for business and whether any of the disallowed business expenses constitute ordinary and necessary expenses paid or incurred during the tax year in pursuit of appellant's property management business. (IRC, § 162(a); *Roberts*, *supra*.)

Therefore, we find that appellant has failed to show that FTB erroneously disallowed the rental expenses in reliance on the federal determination. Appellant has also failed to show she is entitled to any office supplies expenses.

The *Cohan* Rule

In *Cohan v. Commissioner*, *supra*, 39 F.2d at p. 544, producer George M. Cohan testified at trial that he had spent substantial sums of money traveling and entertaining actors, employees, and drama critics in furtherance of his theatrical production business. Cohan could not substantiate by records the actual amounts of such expenditures but instead estimated the amounts in his testimony. The U.S. Board of Tax Appeals found that Cohan had made substantial expenditures and that those expenditures were allowable expenses, but denied any deductions on the grounds that, in the absence of details, it was impossible to determine his actual expenses. On appeal, the Second Circuit Court of Appeals 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." (*Id*. at pp. 543-44.) This holding is referred to as the *Cohan* rule. As noted above, application of the *Cohan* rule was expressly superseded for purposes of expenses requiring heightened substantiation pursuant to Treasury Regulation section 1.274-5T(a), which includes claimed business vehicle expenses and meals.

With respect to expenses claimed by appellant which do not require heightened substantiation, in order to estimate the amount of any expenses under the *Cohan* Rule, we must have some basis upon which an estimate may be made. (*Vanicek v. Commissioner* (1985) 85 T.C. 731, 742-43.) Without such a basis, any allowance would amount to unguided largesse. (*Williams v. U.S.* (5th Cir. 1955) 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 the claimed expenses were incurred. (*Cohan*, *supra*, 39 F.2d at pp. 543-44.)

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However, generalized statements of the expenditures are an insufficient foundation upon which to approximate claimed deductions. (*Appeal of Hakim* (90-SBE-005) 1990 WL 176081.)

Appellant has argued that the additional deductions for rent and office supplies expenses should be allowed pursuant to the *Cohan* Rule. Appellant asserts that the claimed office supplies expenses are customary and necessary to her business as a property manager, because she requires paper and ink in order to produce rental agreements, eviction notices, and invoices. Appellant cites *Dvorak v. Commissioner*, T.C. Memo. 1986-256 (*Dvorak*) where the Tax Court allowed a taxpayer to claim depreciation deductions with respect to certain capitalized costs for tools, carpentry, plumbing, and building supplies.

However, appellant has provided only generalized statements in the appeal briefing rather than documents and explanatory evidence that would justify the claimed office expenses. Appellant's reliance on *Dvorak* is misplaced, because in *Dvorak* the IRS had already stipulated that the taxpayer's remodeling of a small car repair garage into a seven-bedroom house was a business expenditure. Based on this stipulation, the Tax Court concluded that "petitioner must have incurred costs for tools, carpentry, plumbing, and building supplies" and that these capital expenditures were allowable for reducing the taxpayer's cost basis in the house for purposes of determining his allowed depreciation. By contrast, while appellant's claimed expenses *may* be connected with appellant's business as a property manager, appellant has failed to show that they were not for personal use or subject to reimbursement by appellant's employer if related to that employment. (See *Michaels*, *supra*, 53 T.C. at p. 275; *Orvis v. Commissioner* (9th Cir. 1986) 788 F.2d 1406, 1408.) Appellant has not provided evidence of the amount or business purpose for the rent for the business that shares appellant's address. Finally, appellant has not provided any evidence that would properly allow us to estimate the mobile phone, advertisement, or printer ink and paper expenses such as advertisements, which means that we are reliant upon appellant's generalized and incomplete statements. (See *Appeal of Hakim*, *supra*.)

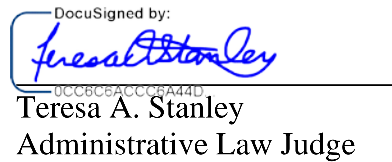
For the foregoing reasons, we find that the use of the *Cohan* Rule is inappropriate in this appeal to estimate appellant's claimed rent or office supplies expenses.

HOLDING

Appellant has not shown error in FTB's proposed assessment, which is based on a federal adjustment disallowing appellant's claimed, unreimbursed business expense deductions.

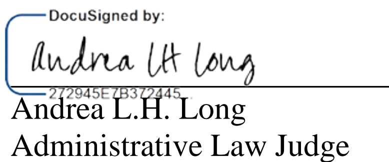
DISPOSITION

FTB's action is sustained.

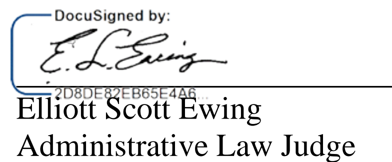


Teresa A. Stanley
Administrative Law Judge

We concur:



Andrea L.H. Long
Administrative Law Judge



Elliott Scott Ewing
Administrative Law Judge

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