OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **G. DALTON AND** **S. DALTON**	) OTA Case No. 19105352)))))

OPINION

Representing the Parties:

For Appellants: G. Dalton

For Respondent: John Yusin, Tax Counsel IV

For Office of Tax Appeals: Neha Garner, Tax Counsel III

T. LEUNG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, G. Dalton and S. Dalton (appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing $6,974 of additional tax for the 2015 taxable year, $9,143 of additional tax for the 2016 taxable year, and $7,482 of additional tax for the 2017 taxable year, plus applicable interest for these years.

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

ISSUES

1. Whether appellants have demonstrated that they incurred their claimed itemized (Schedule A) deductions.
2. Whether appellants are entitled to a worthless debt deduction.
3. Whether appellants underreported capital gains and W-2 wages.

FACTUAL FINDINGS

1. On their California tax returns (Form 540) for the 2015, 2016, and 2017 taxable years, appellants reported federal Schedule A deductions that they failed to substantiate.

Appellants included the following Schedule A deductions on Form 540: (1) medical and dental expenses; (2) personal property taxes; (3) cash and gifts to charity; (4) job expenses and certain miscellaneous deductions; and (5) home mortgage interest not reported on Form 1098 for the 2016 taxable year. Appellants also reported additional medical and dental expense deductions on their Schedule CA for the 2015 and 2016 taxable years due to a difference between California and federal law. However, since appellants failed to substantiate these deductions, FTB disallowed them.

2. Appellants also reported capital losses from worthless debt deductions (worthless debt) on federal Forms 8949 and Schedules D that were included in appellants' Forms 540 in the computation of appellants' California taxable income for each taxable year at issue. FTB disallowed these claimed deductions in the amounts of $2,800 for the 2015 taxable year, $29,000 for the 2016 taxable year, and $31,825 for the 2017 taxable year.
3. FTB issued Notices of Proposed Assessment (NPAs) for the 2015, 2016 and 2017 taxable years to reflect these disallowances and to propose assessments of additional tax, plus interest, in the amounts noted above.
4. For the 2015 taxable year, FTB added back a $2,800 worthless debt deduction to appellants' California taxable income. Appellants also reported a $15 capital loss from the sale of a capital asset using a cost or other basis of $16,281; however, appellant-wife's Internal Revenue Service (IRS) transcript showed a lower cost or adjusted basis of $1,512. Therefore, the $14,769 difference was reflected in the 2015 NPA as an additional capital gain of $14,754 and a disallowed capital loss of $15.
5. Appellant-husband's IRS transcript for the 2016 taxable year indicated he had $446 in wages that were not reported on appellants' 2016 tax return. FTB included this amount in appellants' California taxable income for 2016, as reflected in the 2016 NPA.
6. Because the 2017 worthless debt was disallowed, FTB also disallowed the claimed $3,000 capital loss deduction, which is reflected in the 2017 NPA.
7. On March 28, 2019, FTB sent a letter to appellants explaining the adjustments and NPA amounts owed for the 2015, 2016, and 2017 taxable years. FTB included a form for appellants to complete if they agreed with FTB's adjustments and proposed additional tax amounts. Appellants completed the form on May 27, 2019, indicating that they "agree with the proposed findings of the Franchise Tax Board for the 2015, 2016, and 2017"

taxable years. FTB then issued the NPAs, which appellants protested; FTB subsequently issued Notices of Action sustaining the NPAs.

DISCUSSION

FTB's determination is presumed to be correct, and a taxpayer has the burden of proving error. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509.) Tax deductions are a matter of legislative grace, meaning that taxpayers must show that such deductions clearly meet all the statutory requirements for a deduction. (See *New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435; *Appeal of Walshe* (75-SBE-073) 1975 WL 3557.) Unsupported assertions are not enough to satisfy a taxpayer's burden of proof. (*Appeal of Magidow* (82-SBE-274) 1982 WL 11930.) In the absence of credible, competent, and relevant evidence showing error in a proposed assessment, the proposed assessment must be upheld. (*Appeal of Seltzer* (80-SBE-154) 1980 WL 5068.) Taxpayers' failure to produce evidence that is within their control gives rise to a presumption that such evidence, if provided, would be unfavorable to the taxpayers' case. (*Appeal of Cookston* (83-SBE-048) 1983 WL 15434.)

Issue 1: Whether appellants have demonstrated that they incurred their claimed itemized (Schedule A) deductions.

Appellants agreed with FTB's proposed findings; however, they assert that their tax return preparer was in possession of their substantiating documentation, which was not provided to FTB. It is well established that taxpayers who claim deductions must keep sufficient records to substantiate the claimed deductions. (*Sparkman v. Commissioner* (9th Cir. 2007) 509 F.3d 1149, 1159.) A taxpayer's inability to produce records does not relieve the taxpayer of their burden of proof. (*Villarreal v. Commissioner*, T.C. Memo. 1998-420.) When a taxpayer's records have been lost or destroyed through circumstances beyond his or her control, he or she is entitled to substantiate the deductions by reconstructing the expenditures through other credible evidence. (*Priestly v. Commissioner*, T.C. Memo. 2003-267; *Inzano v. Commissioner*, T.C. Memo. 1998-282.)

In this appeal, appellants have failed to provide any evidence of their efforts to obtain the information from their tax preparer. Furthermore, appellants have failed to demonstrate any efforts to reconstruct the evidence through other sources of information. Appellants have

therefore not met their burden to prove error in FTB's proposed assessments and their Schedule A deductions must be denied.

Issue 2: Whether appellants are entitled to a worthless debt deduction.

Generally, worthless, or bad, debts are deductible. (Int. Rev. Code (IRC), § 166; R&TC, § 17201.) A bad debt must be a bona fide debt that "arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable amount of money." (Treas. Reg. § 1.166-1(c).) The deduction allowed for a bad debt depends on whether it is a business or nonbusiness bad debt. A business bad debt can be partially worthless, and a taxpayer is allowed a partial deduction. (IRC, § 166(a)(2); Treas. Reg. § 1.166-3(a)(2).) A nonbusiness bad debt must be completely worthless before it may be deducted, and it is then completely deductible in the year it became worthless. (Treas. Reg. § 1.166-5(a)(2).) The nonbusiness bad debt rules apply only to noncorporate taxpayers. (IRC, § 166(d).) The loss resulting from a nonbusiness bad debt "shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 1 year"—i.e., a short-term capital loss. (*Ibid*.)

For either a business or nonbusiness bad debt to be deductible, the taxpayer must show that the debt was worthless in the year that the bad debt deduction is claimed. (*Redman v. Commissioner* (1st Cir. 1946) 155 F.2d 319.) The standard for the determination of worthlessness is an objective test of actual worthlessness, a time which is fixed by an identifiable event or events that furnish a reasonable basis for a taxpayer to abandon any hope of future recovery. (*Appeal of Southwestern Development Company* (85-SBE-104) 1985 WL 15875.) Appellants have failed to provide any substantiation related to their bad debt deduction and, therefore, the claimed deduction and resulting $3,000 loss are disallowed.

Issue 3: Whether appellants underreported capital gains and W-2 wages.

California conforms to the general provisions of the IRC relating to the treatment of gain or loss from the disposition of property. (R&TC, § 18031.) IRC section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in IRC section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized. IRC section 1012 generally provides that the basis of property shall be the cost of such property.

Generally, California conforms to section 61 of the IRC (see R&TC, § 17071), which provides that compensation for services is gross income. Here, appellants do not contend that FTB's adjustments to reported capital gains and W-2 wages were erroneous. Therefore, FTB's determination to increase capital gains and W-2 wages for the 2015 and 2016 taxable years, respectively, must be sustained.

HOLDINGS

1. Appellants did not adequately substantiate their claimed Schedule A deductions.
2. Appellants are not entitled to a worthless debt deduction.
3. Appellants underreported capital gains and W-2 wages.

DISPOSITION

FTB's action is sustained.

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Tommy Leung
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Tommy Leung
Administrative Law Judge

We concur:

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E. L. Ewing
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Elliott Scott Ewing
Administrative Law Judge

DocuSigned by:
Sheriene Anne Ridenour
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Sheriene Anne Ridenour
Administrative Law Judge

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