OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 19024335
S. KROWN	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant: Paul J. Finegan, CPA

For Respondent: Eric A. Yadao, Tax Counsel III

A. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, S. Krown (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing additional tax of $7,107.00, a late-filing penalty of $1,776.75, and applicable interest, for the 2016 tax year.[1]

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

ISSUES

1. Whether appellant's income from the University of California, Los Angeles (UCLA) is California source income.
2. Whether appellant is liable for a late-filing penalty.

FACTUAL FINDINGS

1. On January 6, 2016, appellant, a California nonresident, contracted with The Regents of the University of California, a California public corporation, on behalf of the University of California, Medicine – Care Center (UCLA), to provide consulting services.

[1] On appeal, FTB concedes that appellant was a New York resident during 2016 and will allow her to itemize her deductions now that appellant has provided her federal and New York 2016 tax returns to make a more accurate assessment. Therefore, FTB has reduced its proposed tax deficiency to $2,057.00 and the late-filing penalty to $514.25.

Appellant's Statement of Work stated that her scope of services was the following: "provid[e] individual consulting services for the AIDS Malignancy Consortium (AMC)"; serve on the AMC executive committee "as the Vice Chair for International Activities" to "evaluate existing sites while also researching other possible future sites with the long-term goal of expansion and development of the AMC program into a significant number of international markets"; "serve as Protocol Chairs for both clinical trial protocols"; and "address any issues that arise concerning chemotherapy, toxicity management, patient assessments, site personnel training and other issues that may arise relevant to these studies."

2. FTB received information that, during 2016, appellant received non-employee compensation of $109,442 from UCLA. As this amount of income is sufficient to require the filing of a 2016 return, FTB sent appellant a Request for Tax Return (Request), requiring her to file a 2016 return or explain why she was not required to file one.
3. Appellant replied to the Request indicating that she received total gross income from all sources of $122,450 and supported herself in 2016 by "medical consultant/social security." Appellant also indicated that she was not in California at any time during 2016.
4. When FTB inquired about the service or activity she performed for UCLA, appellant explained that she performed consulting services for AMC in 2016, which was funded by the U.S. National Cancer Institute through a grant to UCLA. According to appellant, some of her duties required her to "supervise and coordinate the development of AMC studies at international sites in Africa and Latin America, working with staff at the AMC Operations and Data Management Center located in Rockville, [Maryland] and with staff at the African and Latin American sites." Appellant worked with the Maryland site from her New York residence.

5. FTB thereafter issued a Notice of Proposed Assessment (NPA) with an estimated income of $109,443,[2] a standard deduction of $4,129,[3] and taxable income of $105,314. The NPA proposed a total tax liability of $7,107.00, and imposed a late-filing penalty of $1,776.75, plus interest.
6. Appellant protested the NPA, but FTB issued a Notice of Action, affirming the NPA.
7. This timely appeal followed.

DISCUSSION

Issue 1. Whether appellant's income from UCLA is California source income.

Every individual subject to the Personal Income Tax Law must make and file a return with FTB "stating specifically the items of the individual's gross income from all sources and the deductions and credits allowable" in excess of certain filing thresholds. (R&TC, § 18501(a)(1)-(4).) R&TC section 19087(a) provides that if any taxpayer fails to file a return, FTB at any time "may make an estimate of the net income, from any available information, and may propose to assess the amount of tax, interest, and penalties due." California imposes a tax on the "taxable income of every nonresident" to the extent it is derived from sources within this state. (R&TC, §§ 17041(b) & (i), 17951(a).)

When FTB makes a proposed assessment of additional tax based on an estimate of income, FTB's initial burden is to show that its proposed assessment is reasonable and rational. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Bindley*, 2019-OTA-179P.) An assessment based on unreported income is presumed correct when the taxing agency introduces a minimal factual foundation to support the assessment. (*In re Olshan* (9th Cir. 2004) 356 F.3d 1078, 1084 (citing *Palmer v. Internal Revenue Service* (9th Cir. 1997) 116 F.3d 1309, 1312).) Federal courts have held that the taxing agency need only introduce some evidence linking the taxpayer with the unreported income. (*Rapp v. Commissioner* (9th Cir. 1985) 774 F.2d 932, 935.) When a taxpayer fails to file a valid return, FTB's use of income information from various

[2] It is unclear from the record why FTB's estimate of appellant's income is a dollar more than what UCLA reported on Form 1099-MISC. We also note that, even under FTB's theory, FTB's revised tax computation appears to overstate appellant's California income in that it treats the entirety of appellant's Schedule C gross receipts of $111,723 as being from a California source (generating net income of $86,124), whereas only the $109,442 from UCLA was from a California payor.

[3] In the NPA, FTB treated appellant as if she were a California resident, and applied the standard deduction for a single individual with no dependents.

sources to estimate a taxpayer's taxable income is a reasonable and rational method of estimating taxable income. (See *Palmer v. Internal Revenue Service*, *supra*, at p. 1313.) Once FTB has met its initial burden, the assessment is presumed correct and the taxpayer has the burden of proving otherwise. (*Todd v. McColgan*, *supra*.)

California Code of Regulations, title 18, section (Regulation) 17951-4

In computing the taxable income of a nonresident, the nonresident's gross income "shall be allocated and apportioned under rules and regulations prescribed by [FTB]." (R&TC, § 17954.) Under this grant of authority, Regulation 17951-4 provides income-sourcing rules that apply to a nonresident's income from a business, trade, or profession. (See also Cal. Code Regs., tit. 18, § 17951-2.)[4] FTB argues that appellant was operating a sole proprietorship that was engaged in a unitary business within and without California pursuant to Regulation 17951-4(c).

Regulation 17951-4(c) provides income-sourcing rules for when a nonresident's unitary business, trade, or profession is a sole proprietorship that conducts operations within and without California. Under that regulation, when a sole proprietorship conducts a unitary business within and without California, its income is apportioned to California in accordance with the statutory apportionment provisions of California's Uniform Division of Income for Tax Purposes Act (UDITPA, as codified in R&TC sections 25120-25139). Thus, the requirements for application of Regulation 17951-4(c) are as follows: (1) the taxpayer must be a nonresident; (2) the taxpayer must be conducting business as a sole proprietorship; (3) the taxpayer must be carrying on a unitary business, trade, or profession; and (4) the taxpayer's unitary business, trade, or profession must be conducted within and without California. (*Appeal of Bindley*, *supra*.)

Here, there is no dispute that in 2016 appellant was a nonresident of California who provided consulting services as a sole proprietorship. Thus, the first and second requirements for application of Regulation 17951-4(c) have been met.

[4] Regulation 17951-5 provides rules that apply in allocating the income of various types of nonresident professionals, including physicians. If those rules apply to appellant, a physician, they would cause appellant's income to not be California source income (because appellant performed her services entirely outside of California). We asked the parties to brief whether Regulation 17951-4(c) (applicable to sole proprietorships) or Regulation 17951-5 (applicable to various nonresident professionals) applies here. FTB claims that Regulation 17951-5 is only applicable to employees, not sole proprietors, and therefore it is not applicable to appellant; appellant did not file a brief on this issue. Inasmuch as the conclusion we reach below under Regulation 17951-4 is the same that we would reach under Regulation 17951-5, we decide this case under Regulation 17951-4 without deciding which regulation takes precedence here.

The third requirement of Regulation 17951-4(c) is that appellant's business be unitary. For this purpose, a unitary business can be defined as "a business, trade, or profession conducted both within and without the state, where the part conducted within the state and the part conducted without the state are *not* so separate and distinct from and unconnected to each other to be separate businesses, trades, or professions." (*Appeal of Bindley*, *supra*, at p. 6, original italics.) Here, the evidence shows that appellant's sole proprietorship, based in New York, provided consulting services to UCLA from New York and at least Maryland. Here, as in *Appeal of Bindley*, "Appellant rendered these services … in [appellant's] capacity as an owner of a sole proprietorship. [Appellant], thus, conducted a one-service business, which only [appellant] controlled and managed. There is no indication that would call into question the conclusion that appellant's services were but one interrelated and interdependent business employing and consuming the same resources." (*Id*. at p. 7.) Based on the evidence, we find that appellant's sole proprietorship was a unitary business. Therefore, the third requirement has been met.

The final requirement is that appellant must have been conducting business within and without California. This requirement has not been met because there is no evidence that she was conducting business in California, and as discussed below, she did not derive California source income.

California's Market-Based Sales Factor Sourcing Provisions

Regulation 17951-4(c)(2) provides that "[t]he amount of such business income derived from sources within [California] shall be determined in accordance with the provisions of the apportionment rules of the Uniform Division of Income for Tax Purposes Act, [s]ections 25120 to 25139, inclusive, Revenue and Taxation Code, and the regulations thereunder …."

A multistate taxpayer engaged in a unitary business must apportion its business income according to the UDITPA. (R&TC, § 25121; see also Cal. Code Regs., tit. 18, § 25121.) With certain exceptions not relevant here, for taxable years beginning on or after January 1, 2013, all business income of an apportioning business must be apportioned to California using only the sales factor.[5] (R&TC, § 25128.7.) The sales factor is a fraction, where the numerator is the taxpayer's total sales in California during the tax year and the denominator is the taxpayer's total

[5] For a taxpayer engaged in providing services, "sales" includes the gross receipts from the performance of such services including fees, commissions, and similar items. (Cal. Code Regs., tit. 18, § 23514(a)(1)(C).)

sales everywhere during the tax year. (R&TC, § 25134; see also Cal. Code Regs., tit. 18, § 25134.)

For purposes of determining what amount is included in the numerator of the sales factor, R&TC section 25136 governs the assignment of receipts from sales other than sales of tangible personal property, such as service revenue. It provides that receipts from sales of services are in California to the extent the purchaser of the services received the benefit of the services in California. Under the statutory grant of authority of R&TC section 25136(b), FTB promulgated Regulation 25136-2, which provides detailed sourcing rules that implement and interpret R&TC section 25136.

Regulation 25136-2(c) provides that "[s]ales from services are assigned to [California] to the extent the customer of the taxpayer receives the benefit of the service in [California]." The phrase "benefit of a service is received" is defined as "the location where the taxpayer's customer has either directly or indirectly received value from delivery of that service." (Cal. Code Regs., tit. 18, § 25136-2(b)(1).) Regulation 25136-2(c)(2) provides that, when a corporation or other business entity is the taxpayer's customer, such as in this appeal, receipt of the benefit of the service shall be determined under the following cascading rules.

> (A) The location of the benefit of the service shall be presumed to be received in this state to the extent the contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records kept in the normal course of business, notwithstanding the billing address of the taxpayer's customer, indicate the benefit of the service is in this state. This presumption may be overcome by the taxpayer or [FTB] by showing, based on a preponderance of the evidence, that the location (or locations) indicated by the contract or the taxpayer's books and records was not the actual location where the benefit of the service was received.
>
> (B) If neither the contract nor the taxpayer's books and records provide the location where the benefit of the service is received, or the presumption in subparagraph (A) is overcome, then the location (or locations) where the benefit is received shall be reasonably approximated.
>
> (C) If the location where the benefit of the service is received cannot be determined under subparagraph (A) or reasonably approximated under subparagraph (B), then the location where the benefit of the service is received shall be presumed to be in this state if the location from which the taxpayer's customer placed the order for the service is in this state.

> (D) If the location where the benefit of the service is received cannot be determined pursuant to subparagraphs (A), (B), or (C), then the benefit of the service shall be in this state if the taxpayer's customer's billing address is in this state.

Applying the first cascading rule, the contract between appellant and UCLA specifies, among other things, that appellant's scope of work involves working with the AMC, serving on the AMC's executive committee as vice-chair, and serving as protocol chairs for two clinical trial protocols. This description specifies how her expertise will be utilized and where appellant's services will be performed (New York) but does not state the location(s) where the benefit of the services will be received. It does not identify the location(s) of the AMC, where the AMC executive committee meets, or where the clinical trials take place.

FTB points to Regulation 25136-2(c)(2)(A) for the presumption that the benefit was received in California. However, this presumption only arises if appellant's contract with UCLA specifically states the benefit of the services was received in California. Nothing in the language of the contract states that.[6] Therefore, we cannot source appellant's income from UCLA under this rule.

Applying the second cascading rule, we can reasonably approximate the location where UCLA received the benefit of appellant's services. "Reasonably approximated" means, in relevant part, "considering all sources of information other than the terms of the contract and the taxpayer's books and records kept in the normal course of business, the location of the market for the benefit of the services . . . is determined in a manner that is consistent with the activities of [UCLA] to the extent such information is available to [appellant]." (Cal. Code Regs., tit. 18, § 25136-2(b)(7).)

Appellant alleges that the AMC is a clinical trials group funded by the U.S. National Cancer Institute through a grant to UCLA. Appellant explained, in correspondence to FTB, that some of her duties included supervising and coordinating the development of AMC studies located in Africa and Latin America from her New York residence. She also explained that she periodically visited the international sites in Africa and Latin America. Additionally, she worked with staff at the AMC Operations and Data Management Center located in Maryland from her

[6] In this regard, we reject FTB's argument that the contract's inclusion of stock language stating that the parties to the contract did not intend to create third-party beneficiaries requires us to conclude that the services appellant provided under the contract only benefitted the other signatory to the contract, UCLA, in California.

New York residence. We believe that her scope of services supports these allegations because it indicates she is responsible for coordinating the AMC's "efforts at both existing and future *international* clinical sites with the long-term goal of expansion and development of the AMC program into a significant number of *international* markets." (Italics added.) Appellant also provides a letter from the AMC Group Chair, corroborating that appellant's consulting agreement was to support a federal cooperative research agreement, which was awarded to UCLA by the National Cancer Institute/National Institute of Health. Accordingly, based on the uncontested assertions by appellant, we find that we can reasonably approximate that the benefit of appellant's services was received in Africa, Latin America, and Maryland, all of which are outside of California. We therefore find that appellant's income from UCLA is not California source income.

Issue 2. Whether appellant is liable for a late-filing penalty.

Since appellant did not have any California source income in 2016, she was not required to file a California return for that year. Hence, she is not liable for a late-filing penalty for that year.

HOLDING

The income that appellant received from the UCLA is not California source income.

DISPOSITION

FTB's action is reversed.

DocuSigned by:
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Andrea L.H. Long
Administrative Law Judge

We concur:

DocuSigned by:
CF2E977BFB79472...
Kenneth Gast
Administrative Law Judge

DocuSigned by:
177BAD36C0B3437...
Jeffrey I. Margolis
Administrative Law Judge

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