OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18010027
M. CREAMER AND	)
M. CREAMER	)
	)

OPINION

Representing the Parties:

For Appellants:	A. Lavar Taylor, Esq.
For Respondent:	Gi Nam, Tax Counsel Maria Brosterhous, Tax Counsel IV
For Office of Tax Appeals:	Matthew D. Miller, Tax Counsel III

J. JOHNSON, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, appellants M. Creamer and M. Creamer appeal an action by respondent Franchise Tax Board in proposing additional tax of $34,094 for the 2010 tax year.

Office of Tax Appeals (OTA) Administrative Law Judges John O. Johnson, Jeffrey I. Margolis, and Richard Tay, held an oral hearing for this matter in Los Angeles, California, on September 19, 2019. At the conclusion of the hearing, the record was held open to facilitate an additional briefing request. The record was subsequently closed on November 20, 2019, and this matter was then submitted for decision.

ISSUE

Have appellants shown error in respondent's proposed assessment, which is based on a final federal determination?[1]

[1] Respondent's proposed assessment also includes an accuracy-related penalty of $6,818.80 and interest. Appellants do not argue that the penalty or interest should be abated on separate grounds, but instead contend that both penalty and interest should be recalculated based on any adjustment to the proposed assessment of additional tax.

FACTUAL FINDINGS

1. Appellants filed a timely 2010 California income tax return, reporting California taxable income of $19,434.
2. During 2010, appellant-husband was a California attorney that practiced law through his law firm, a sole proprietorship.
3. The Internal Revenue Service (IRS) audited appellants' 2010 tax year. During the audit, the IRS issued a request for documents in February 2013, which requested canceled checks and other evidence supporting certain claimed deductions, including payments made to Ms. Schultz, who appellants allege worked as appellant-husband's associate attorney during 2010.
4. Sometime in early 2013, appellant-husband moved offices. Appellant-husband had copies of bank records for 2010 immediately prior to the move, but he did not take the records with him to his new office.
5. In April 2014, the IRS completed its audit of appellants' 2010 tax year and assessed additional tax of $131,138 and imposed an accuracy-related penalty of $26,768.20. The audit resulted in a $385,533 increase to appellants' taxable income. The increase was based on additional gross receipts of $363,292 as reported on Form 1099s from insurance companies (1099 income), the disallowance of $32,799 in claimed expenses for legal and professional services, and the allowance of a $10,558 deduction for self-employment tax. The IRS provided information regarding the results of the federal audit to respondent that same month.
6. In June 2014, appellants submitted an audit reconsideration request to the IRS with an amended return and a signed affidavit from Ms. Schultz, regarding payments she received through her work with appellant-husband's law practice.[2] The affidavit was written by appellant-husband, with an executed date of March 27, 2013, and has a notarized date of June 10, 2014. The IRS did not reopen the audit and made no subsequent adjustments to its audit findings.
7. Based on the federal adjustments, respondent issued a Notice of Proposed Assessment

[2] In the request for documentation issued by the IRS in February 2013, the IRS asked for a notarized statement from Ms. Schultz attesting to the amounts she received from appellant-husband, if appellants could not provide cancelled checks. Appellants were asked to provide this declaration by March 28, 2013, but did not provide the declaration until June 2014, after the audit had closed.

(NPA) for 2010. The NPA increased appellants' taxable income by the $385,533 noted above. The NPA proposed additional tax of $34,094 and an accuracy-related penalty of $6,818.80 (20 percent of the additional tax amount), plus applicable interest.

8. Appellants timely protested the NPA, asserting that they disagreed with the proposed assessments and the federal adjustments. With their protest, appellants submitted an amended California income tax return that accepted the IRS's adjustment to appellants' gross income but claimed an additional $387,691 of expenses for contract labor for amounts allegedly paid to Ms. Schultz. Also attached to the protest was the affidavit of Ms. Schultz, and documents from the IRS audit.

9. On April 24, 2017, respondent issued a Notice of Action affirming the NPA in full. This timely appeal followed.

10. On appeal, appellants clarified that they are not seeking any deductions for business expenses or otherwise (in particular, that they do not contest the IRS's and respondent's disallowance of $32,799 of expenses for legal and professional services claimed in their originally filed 2010 returns), aside from a deduction of $341,494.48[3] to be applied against the 1099 income of $363,292, as discussed herein. Appellant-husband testified and submitted his own affidavit in support of appellants' contentions.

DISCUSSION

A deficiency assessment based on a federal audit report is presumptively correct, and the taxpayer bears the burden of proving that the determination is erroneous. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Brockett* (86-SBE-109) 1986 WL 22731.) Where, as here, respondent's proposed assessment is based on a final federal determination, a taxpayer may show that either respondent's determination, or the federal determination upon which it is based, is incorrect. However, unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof with respect to an assessment based on a federal action. (*Appeal of Magidow* (82-SBE-274) 1982 WL 11930.) Furthermore, it is well established that the failure of a party to introduce evidence which is within his or her control gives rise to the presumption that, if provided, it would be unfavorable. (*Appeal of Cookston* (83-SBE-048) 1983 WL 15434.)

[3] This amount is 94 percent of the 1099 income. Appellants assert that of the total 1099 income, 60 percent was issued to the clients, and 85 percent of the remaining 40 percent was paid to Ms. Schultz. Appellants concede on appeal that the remaining amount of $21,797.52, or 6 percent of the total 1099 income, is taxable to appellant-husband.

Here, respondent proposed an assessment of additional tax based on final federal adjustments for the 2010 tax year. Appellants allege that the IRS grossly overstated their income and assert that new evidence in the forms of an affidavit executed by Ms. Schultz (and drafted by appellant-husband), together with appellant-husband's own affidavit and testimony, prove that respondent's proposed assessment, and the federal determination on which it is based, are erroneous. Respondent contends that its proposed assessment, and the IRS determination that it is founded upon, are based on unreported income received by appellant-husband, and that appellants have not supported any claimed deductions on appeal.

Before addressing appellants' affidavits, we address the evidence surrounding the IRS's determination. The evidence shows that appellant-husband received $363,292 in unreported 1099 income through his law firm in the form of recoveries from insurance companies. There is no indication that appellants provided any evidence in support of their arguments during the federal audit.[4] From the document request issued by the IRS in February 2013, we see that the arguments appellants made to the IRS are similar to those they made at protest with respondent and here on appeal. In particular, appellants assert that portions of the unreported 1099 income were paid to Ms. Schultz and constitute taxable income to her, not to appellants. The IRS asked for copies of cancelled checks for the 2010 year to substantiate these assertions, or as an alternative a notarized statement from Ms. Schultz detailing the amounts she received.

With respect to the IRS's request for cancelled checks, it does not appear appellants provided any checks or other bank-related evidence during the federal audit. Appellant-husband testified that he abandoned the relevant 2010 bank statements when he moved offices in early 2013. Appellant-husband asserts that had he known that he was being audited, he would have kept those records; however, the IRS's February 2013 document request shows that he was clearly being audited at the time he claims he was moving offices. The documents requested by the IRS are undoubtedly based on assertions made by appellants in response to previous inquiries by the IRS into appellants' 2010 tax year (e.g., the involvement of Ms. Schultz). Accordingly, we find that appellant-husband knew of the audit prior to his move, and yet he failed to keep bank records that were deemed important to the audit by the IRS (and subsequently by this appellate body).

[4] Appellants eventually provided an amended return and the affidavit from Ms. Schultz to the IRS, but these documents were provided after the federal audit closed, as part of an unsuccessful request for reconsideration at the federal level.

Regardless of whether appellant-husband had received the specific request for cancelled checks from the IRS prior to completing his office move, he was aware that the 2010 tax year was being audited, and he should have retained bank records pertinent to that year until the audit was resolved rather than dispose of them within two years of having filed his returns. "Taxpayers are required to maintain records sufficient to establish the amounts of income, deductions, and other items which underlie their federal income tax liabilities. [IRC] Sec. 6001; sec. 1.6001-1(a), (e), Income Tax Regs." (*Canatella v. Commissioner*, T.C. Memo. 2017-124; see also *Allen v. Commissioner* (1967) T.C. Memo. 1967-105 ["The taxpayer, and especially the business taxpayer, has a duty to keep records of the total amounts of all varieties of income received by him so that he may show himself and the Commissioner the quantity of such income"].)[5] While appellants assert that the bank records would not have been helpful in resolving the matter before us, that seems very unlikely to be the case.

The very question before us is whether any portion of the over $363,000 in unreported 1099 income appellant-husband received from insurance companies in 2010 should not be considered taxable income to him. Appellant-husband concedes that he received the 1099 income at issue and that he deposited them into his trust account with the bank, and he claims that after a day or two he would withdraw the funds to distribute to clients and Ms. Schultz. Surely such deposits and withdrawals would be reflected on his bank statements, and if he promptly withdrew the amounts as separate cashier's checks, as he asserts, the records should reflect deposited funds being withdrawn in separate amounts reflecting the 60 percent allegedly paid to clients, and the 40 percent allegedly retained by counsel (either as one amount that all went to Ms. Schultz, as appellant-husband asserts happened at times, or in the asserted fee-splitting ratio between Ms. Schultz and appellant-husband of 85/15).[6] Appellant-husband's assertion that he used a client trust account with a bank to handle the dispersal of settlement proceeds from civil suits but that the bank records would not show those transactions (or

[5] Appellant-husband appears to also have been required to maintain records relating to the transactions in his client trust account in accordance with the rules of the State Bar of California. (*Fitzsimmons v. State Bar of California* (1983) 34 Cal.3d 327, 331-332; see also former California Rule of Professional Conduct 4-100(B)(3), effective beginning 1993, and current Rule 1.15(d)(5), effective beginning November 1, 2018 [requiring attorneys to maintain records of disbursements of client funds for five years].)

[6] Appellant-husband testified that the first few instances of 1099 income were handled via this cashier's check process, and later fee-splitting activity was conducted through bank transfers from his client trust account to a separate trust account maintained by Ms. Schultz. The same conclusion is drawn that such transfers would likewise be captured and reported on bank statements.

otherwise be helpful in resolving key questions of fact on appeal) is, at best, dubious.

Rather, the question of whether appellants' story is accurate would most likely be solved by the production of those bank records, either confirming the deposit and withdrawal activity or revealing that such activity was not reflected on the bank statements. Either way, appellant-husband had the bank statements that were crucial to providing this answer, knew he was under audit for the 2010 year (and possibly knew that the IRS was requesting those very documents), and yet decided to not retain those documents. Furthermore, appellants have not shown any attempt to request copies of those statements from the bank, despite requests for them from the IRS. This is a situation in which appellants had evidence within their control that they failed to provide, and gives rise to the presumption that, if those bank statements were provided, they would be unfavorable to appellants' position. (See *Appeal of Cookston*, *supra*.)

Appellants concede that a Form 1099-MISC was not issued to Ms. Schultz, despite asserting that no less than 36 percent of the total 1099 income (i.e., roughly $123,500) was paid to her by appellant-husband's firm in 2010, which would necessitate the issuance of a Form 1099-MISC under Internal Revenue Code (IRC) section 6041. Furthermore, federal wage and transcript information provided after the hearing shows that none of the 1099 income was reported as being paid to Ms. Schultz.[7]

On appeal, appellants were asked by OTA to provide additional documentation in preparation for the oral hearing. Appellants were able to provide identifying information for Ms. Schultz, allowing for the above-mentioned discovery that none of the income at issue was reported as her income. Appellants were also asked to provide bank statements showing payments from appellant-husband's firm to Ms. Schultz or clients and any documents that showed that Ms. Schultz was at all involved with appellant-husband's firm (e.g., contractor or employee agreements, fee-sharing agreements, or any firm-related work product listing both appellant-husband and Ms. Schultz). Appellants said they were unable to provide any such

[7] That documentation appears to also show that Ms. Schultz did not file returns for the year at issue, and therefore did not report any of the income herself.

documentation.[8] When asked at the hearing if there were any written or emailed agreements regarding fee-splitting or retainers for Ms. Schultz in 2010, appellant-husband testified that everything was done by verbal agreement.[9]

A fundamental question on appeal is whether appellants have shown that a significant portion of the gross income at issue constituted the clients' portions of settlement proceeds, which were redistributed to clients and therefore not considered taxable income to appellant-husband. Under Treasury Regulation 1.6045-5, payors making payments to attorneys have unique reporting requirements determined by how they issue settlement checks. Relevant to the facts before, there are two options of how settlement payments may have been reported on the Form 1099s at issue, illustrated by examples 1 and 3 of Treasury Regulation section 1.6045-5(f). The payors may have issued settlement checks payable jointly to the plaintiffs and to appellant-husband, in which case they issued two Form 1099s, both for the full amount, to both the plaintiffs and appellant-husband (Example 1). Alternatively, the payors may have issued two settlement checks, one payable to the plaintiffs and one payable to appellant-husband for their respective shares, in which case the payors issued two Form 1099s, one to the plaintiffs for the full amount, and one to appellant-husband just for the attorney's fees (Example 3). (Treas. Reg. § 1.6045-5(a)(1), (b)(ii), (f), Examples 1 & 3.)[10] Accordingly, Example 1 represents a scenario in which only a portion of the 1099 income would be considered taxable to appellant-husband, whereas Example 3 represents a scenario in which the entirety of the 1099 income is taxable to appellant-husband.

Appellants allege that the $363,292 in unreported 1099 income reflects settlement

[8] Appellants responded to both requests by stating that a concerted effort was made to locate bank statements, but that none were available at this time. It is not clear how that statement accurately addresses the request for evidence showing that Ms. Schultz had a working relationship with appellant-husband's firm, but we assume it also means that no evidence was located in response to this request.

[9] Earlier in the hearing, during appellant-husband's testimony, he stated that he (at one point) had retainer agreements for 9 of 10 court cases, and that Ms. Schultz would have had a similar document for the 10th case. Appellant-husband did not provide copies of any of those retainer agreements, but provided a sample retainer agreement with his affidavit, unrelated to any of the 2010 activity at issue. Based on the inconsistent testimony, it is unclear whether appellant-husband had agreements in writing regarding these cases or not, and if so, with whom. The ultimate result of the inquiry into such documentation, however, is that appellants have not provided retainer agreements or any other requested documentation that support their contentions.

[10] In some instances, payors may issue a single settlement check payable only to the plaintiff, in which case a single Form 1099 would be issued only to the plaintiff. However, that is not the case here, as appellant-husband was issued Form 1099s for the amounts at issue. (Treas. Reg. § 1.6045-5(a)(1), (f), Example 4.)

payments issued under Example 1. If this is accurate, it means that the insurance companies and other payors issued settlement checks payable *jointly* to appellant-husband's firm and to his clients. However, appellants fail to provide documentary evidence, such as settlement awards, copies of deposited checks, or proof of payments to the clients or Ms. Schultz, to substantiate this contention, despite such documentary evidence presumably being within their control and having been requested during the federal audit, respondent's protest, and this appeal. As such, appellants have not met their burden of showing error in the determination of the IRS and respondent, both of which treated the settlement payments as being made under Example 3. If appellants had any documentary evidence to support their position that appellant-husband only retained 6 percent of the 1099 income, such evidence should have been presented long ago.

To summarize the evidence to this point, ignoring for the moment testimony and affidavits provided by appellants, the evidence in the record before us shows that appellant-husband received $363,292 in unreported 1099 income in 2010, and there is no banking or other evidence showing that any of these funds were redistributed to clients or Ms. Schultz. Other than the testimony and affidavits provided by appellants, there is also no evidence showing that Ms. Schultz had any relation to appellant-husband's law firm or the activity that generated these gross receipts. Appellants have also not shown by documentary evidence that the amounts reflected on the Form 1099s included amounts that were due to appellant-husband's clients and were duly distributed either to those clients or to Ms. Schultz. Appellants appear to solely rely on the affidavits and testimony to meet their burden of proof.

Respondent's determination cannot be successfully rebutted when appellants fail to present credible, competent, and relevant evidence as to the issues in dispute. (*Appeal of Seltzer* (80-SBE-154) 1980 WL 5068; see also *Banks v. Commissioner* (8th Cir. 1963) 322 F.2d 530, 537.) Appellants bear the burden of proving error in respondent's determination. Affidavits and testimony are provided appropriate probative weight based on their alignment with the evidentiary record as a whole. For purposes of appeals before the OTA, affidavits or declarations will be given the same probative effect as if the affiant had testified orally at the hearing, but only if certain requirements are met, including providing the opposing party the chance to cross-examine the affiant. (Cal. Code Regs., tit. 18, § 30420(c); see also Gov. Code, § 11514.) When the opportunity to cross-examine is not afforded, then the affidavit shall be given only the same effect as other hearsay evidence. Here, appellant-husband testified at the

oral hearing and was made available for cross-examination, and therefore his affidavit shall be treated as part of his oral hearing testimony. Ms. Schultz, however, was not made available for cross-examination. Accordingly, her affidavit shall be given the weight of administrative hearsay, requiring supporting documentation to prove the facts asserted therein. (See *Lake v. Reed* (1997) 16 Cal.4th 448.)

According to appellant-husband's affidavit and testimony, Ms. Schultz practiced under the name Creamer and Associates for cases assigned to her by appellant-husband in 2010. Appellant-husband asserts that because she worked on his cases without his input, he agreed to split the attorney's fees from contingency cases with 85 percent going to Ms. Schultz and 15 percent to himself. The affidavits and testimony state that, at some point, Ms. Schultz moved out of the area and into her own office but continued to work on appellant-husband's automobile accident and personal injury cases. Appellant-husband affirmed that when he prepared his 2010 tax returns, he forgot about the cases that his associate allegedly worked on under his name, and he claims that he did not include any of the associated 1099 income because those forms were sent to Ms. Schultz's office.

Appellants assert that no evidence contradicts the statements made in the affidavits; however, we disagree.[11] Furthermore, to the extent that certain statements made in the affidavits and testimony are not directly contradicted by evidence in the record, it appears as though the lack of potentially contradictory evidence is wholly based upon appellants' failure to provide documentation requested by the IRS, respondent, and OTA. Appellants' failure to provide evidence within their control cannot be used to support their position, and instead such failure leads to the presumption that such evidence, if provided, would be unfavorable to their position. The lack of contradictory evidence is also counterbalanced by the lack of any reliable source documentary evidence whatsoever. Appellants have not provided any documentary evidence showing the trail of over $363,000 paid to appellant-husband, of which appellant-husband asserts he only retained 6 percent. Appellants were on notice within two years of filing their 2010 tax returns that they should provide such documentary evidence, and instead opted to dispose of requested bank information in their custody and provide no documentary support.

[11] We note that there exist inconsistencies in the affidavits and testimony themselves, including the name under which Ms. Schultz practiced law in 2010, who issued the clients their portion of the awards, and the amount of 1099 income Ms. Schultz received from appellant-husband in 2010. The inconsistencies are especially troubling since Ms. Schultz affidavit, appellant-husband's affidavit, and appellant-husband's testimony at the hearing were all authored by appellant-husband.

While appellants assert that respondent places too much emphasis on the result of the federal audit, during which appellants assert they were poorly represented, the fact remains that appellants have not provided any evidence to counter the findings of the IRS or respondent other than unsupported assertions. Therefore, we conclude that appellants have not satisfied their burden of showing error in the final federal determination and have not overcome the presumption of correctness in respondent's determination based thereon.

HOLDING

Appellants have not shown error in respondent's proposed assessment, which is based on a final federal determination.

DISPOSITION

Respondent's action is sustained in full.

DocuSigned by:
John O Johnson
873D9797B9E64E1...
John O. Johnson
Administrative Law Judge

I concur:

DocuSigned by:
F8E81582726F448...
Richard Tay
Administrative Law Judge

J. MARGOLIS, Concurring and Dissenting in part:

I concur with the foregoing opinion except that I find that appellant-husband's testimony credibly supported appellants' contention (which I also find reasonable) that 60 percent of the amount reflected on the Form 1099s paid by the insurance companies included amounts that were owed – and paid – to appellant-husband's clients. Accordingly, I would reduce the amount of unreported income by 60 percent. As stated in *Canatella v. Commissioner*, T.C. Memo. 2017-124:

> As a general rule, funds that a taxpayer receives in trust for another person are not includable in the taxpayer's gross income. *Ford Dealers Advert. Fund, Inc. v. Commissioner*, 55 T.C. 761, 771 (1971), *aff'd*, 456 F.2d 255 (5th Cir. 1972). Under this general rule, if a lawyer receives funds that professional regulations require to be segregated from other funds and accounted for separately, the funds are not includable in the income of the lawyer. *Miele v. Commissioner*, 72 T.C. 284, 290 (1979).

In all other respects, I agree with the majority opinion.

DocuSigned by:
Jeffrey I. Margolis
5E9822FBB1BA41B...
Jeffrey I. Margolis
Administrative Law Judge

Date issued: 2/28/2020