OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 19034571
J. SORIA AND	)
M. HUGHES	)
	)
	)

OPINION

Representing the Parties:

For Appellants: J. Soria
M. Hughes

For Respondent: Joel M. Smith, Tax Counsel III

S. RIDENOUR, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, J. Soria and M. Hughes (appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing $9,162.00 of additional tax, an accuracy-related penalty of $1,832.40, and applicable interest, for the 2014 tax year.

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

ISSUES

1. Whether appellants have shown error in the proposed assessment, which is based on information provided by the Internal Revenue Service (IRS).
2. Whether appellants have demonstrated that the accuracy-related penalty should be abated.

FACTUAL FINDINGS

1. Appellants timely filed a joint 2014 California return (Form 540) reporting federal adjusted gross income (AGI) of $81,416 and total tax of $171. Appellants included with their return a 2014 federal return (Form 1040), also reporting federal AGI of $81,416. FTB accepted the California return as filed.

2. Subsequently, the IRS provided information to FTB, as reflected on a FEDSTAR IRS Data Sheet (Fedstar Sheet), indicating that appellants reported on their 2014 federal return a federal AGI of $124,819, which, upon examination, the IRS increased to $393,460. The IRS made numerous adjustments, such as disallowing claimed Schedule A deductions and Schedule C expenses, and including unreported Schedule C gross receipts or sales income. The IRS increased appellants' federal taxable income, proposed additional tax, and imposed an accuracy-related penalty. Appellants did not inform FTB of the federal changes.
3. Based on the information the IRS provided, FTB made corresponding adjustments to appellants' California taxable income, to the extent applicable under California law, and issued appellants a Notice of Proposed Assessment (NPA). The NPA disallowed a portion of claimed Schedule A deductions and Schedule C expenses, included unreported Schedule C gross receipts and sales income as well as an itemized deduction limitation adjustment, and allowed a self-employment tax deduction. The NPA increased appellants' California taxable income by $274,646, and proposed additional tax and an accuracy-related penalty, plus interest.
4. Appellants protested the NPA, contending that they filed an amended 2014 federal tax return (Form 1040X), which the IRS accepted. Appellants attached to their protest letter an installment payment agreement with the IRS for tax years 2013 through 2016, which was entered into after appellants filed their 2014 amended federal return, as well an amended joint 2014 California return (Form 540X). The amended California return reported a federal AGI of $124,819. On the amended California return, appellants explained the reason for the changes was due to the tax return preparer claiming deductions that appellants "did not have or provide to the preparer."
5. FTB obtained a copy of appellants' 2014 federal Account Transcript from the IRS, which showed that appellants filed a joint amended federal return in September 2017, reporting a 2014 federal AGI of $231,337, which was accepted by the IRS.
6. After reviewing the information appellants provided, as well as appellants' 2014 federal Account Transcript, FTB issued a Notice of Action (NOA) that revised, but in all other respects affirmed, the NPA. The NOA reflected a reduction of $162,123 for "FED AGI

Adjustment"[1] and removal of the itemized deduction limitation. The NOA increased appellants' taxable income by $110,084 (instead of $274,646, as reflected in the NPA), for a revised total tax of $9,333. The NOA proposed additional tax of $9,162.00, and an accuracy-related penalty of $1,832.40, plus applicable interest.[2] The NOA explained that since appellants' amended California return did not match the federal adjustments as reported by the IRS, FTB declined to accept the amended return as filed.

7. This timely appeal followed.

DISCUSSION

Issue 1. Whether appellants have shown error in the proposed assessment, which is based on information provided by the IRS.

R&TC section 17041(a)(1) imposes a tax upon the entire taxable income of every resident of this state. R&TC section 18501(a) requires every individual subject to the Personal Income Tax Law to 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 ...." The federal definition of AGI found in Internal Revenue Code (IRC) section 62 is incorporated into California law by R&TC section 17072. Accordingly, taxpayers must report the same federal AGI on both their federal and California returns, except as otherwise provided by California law.

R&TC section 18622(a) provides that a taxpayer shall either concede the accuracy of a federal determination or state wherein it is erroneous. FTB's determination of tax is presumed to be correct, and a taxpayer has the burden of proving error. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Davis*, 2020-OTA-182P.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Gorin*, 2020-OTA-018P.)

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[1] This adjustment amount accounts for the difference between appellants' federal AGI of $393,460 upon federal audit and their federal AGI of $231,337 as reported on their accepted federal amended return (i.e., $393,460 - $231,337 = $162,123).

[2] While appellants filed a 2014 California return reporting federal AGI of $81,416, and provided a federal return allegedly reporting the same, the IRS provided FTB information indicating that appellants actually reported on their filed 2014 federal return a federal AGI of $124,819 (for a difference of $43,403 in reported federal AGI). However, both the NPA and NOA used the taxable income appellants reported on their California return, which was calculated using federal AGI of $81,416. While the NPA and NOA made adjustments based on the information the IRS provided, neither notice first increased appellants' California AGI by the unreported federal AGI of $43,403, in order for appellants' California AGI to properly reflect the same federal AGI as actually reported on their filed federal return, and then make corresponding California adjustments based on the federal adjustments. Since this appears to be an oversight in appellants' favor, we will not discuss it further.

A taxpayer must report federal changes to income or deductions to FTB within six months of the date the federal changes become final. (R&TC, § 18622(a).)

Appellants contend that the IRS accepted appellants' 2014 amended federal return, a copy of which appellants included with their appeal, along with a copy of appellants' 2014 amended California return, which FTB did not accept as filed.

Appellants reported on their amended California return a federal AGI of $124,819. However, appellants reported on their amended federal return a federal AGI of $231,337, which, according to appellants' 2014 federal Account Transcript, was accepted by the IRS. As such, appellants' amended California return did not match the federal AGI as reported on appellants' 2014 federal Account Transcript. Therefore, we find that FTB has demonstrated that appellants' California return erroneously understated their federal AGI, and appellants have not established otherwise.

Based on federal adjustments as reflected on the Fedstar Sheet, FTB issued appellants an NPA which, among other adjustments, disallowed a portion of claimed Schedule A deductions and Schedule C expenses, and included unreported Schedule C gross receipts and sales income. Subsequently, appellants filed an amended federal return reporting a federal AGI of $231,337, which the IRS accepted as filed. In response, FTB revised the proposed assessment before issuing the NOA. Specifically, the NOA reflected a taxable income reduction of $162,123 for "FED AGI Adjustment," which is the difference between the federal AGI amount the IRS assessed during federal examination (i.e., $393,460) and the federal AGI amount that appellants reported on their amended federal return, as accepted by the IRS (i.e., $231,337).

While the NOA did not make specific revisions for Schedule C adjustments, the NOA nevertheless accounted for the adjustments. A taxpayer's net profit or loss, as reported on a Schedule C (Profit or Loss from Business), is entered on a taxpayer's Form 1040 line 12 (Business income or (loss)), which is used to calculate the taxpayer's income, and eventually the taxpayer's AGI. Therefore, an adjustment to a taxpayer's AGI can reflect corresponding Schedule C adjustments, such the decrease in appellants' federal AGI from $393,460 to $231,337 (or, by $162,123). As for the disallowed claimed Schedule A deductions, appellants have not demonstrated what portion, if any, the IRS subsequently allowed. Regardless, we are not bound to adopt the conclusion reached by the IRS, even when that determination results from a detailed audit. (*Appeal of Pryke* (83-SBE-212) 1983 WL 15583.) Appellants have provided no

documentation substantiating the claimed Schedule A deductions for our consideration on appeal. As such, appellants have not met their burden of demonstrating error in FTB disallowing the claimed Schedule A deductions.

Based on the foregoing, we conclude that appellants have not met their burden of establishing error in FTB's proposed assessment.

Issue 2. Whether appellants have demonstrated that the accuracy-related penalty should be abated.

IRC section 6662, incorporated by R&TC section 19164, provides for an accuracy-related penalty of 20 percent of the applicable underpayment. IRC section 6662(b) provides, in relevant part, that the penalty applies to the portion of the underpayment attributable to any substantial understatement of income tax. A substantial understatement of tax exists if the understated amount exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000. (IRC, § 6662(d)(1).) An "understatement" is defined as the excess of the amount of tax required to be shown on the return for the tax year over the amount of the tax imposed which is shown on the return, reduced by any rebate. (IRC, § 6662(d)(2).) The accuracy-related penalty does not apply to any portion of an underpayment if it is shown that there was reasonable cause for the underpayment and the taxpayer acted in good faith with respect to the underpayment. (IRC, § 6664(c)(1).)

The proposed assessment is for a revised total tax of $9,333, while appellants reported tax of $171. The understatement of $9,162 (i.e., $9,333 - $171) exceeds $5,000, which is the greater of 10 percent of the tax required to be shown on the return (i.e., $933, or 10 percent of $9,333). Accordingly, the penalty is properly imposed based on the substantial understatement of tax.

Appellants provide no evidence or argument to show reasonable cause for the substantial underpayment. Rather, appellants provide the same evidence and argument regarding the filing of amended returns. However, as discussed above, appellants have not established error in FTB's proposed assessment. While there are exceptions that allow for the accuracy-related

penalty to be reduced or eliminated,[3] appellants do not provide any argument or evidence establishing that any of the exceptions apply. Accordingly, appellants have not shown that the accuracy-related penalty should be abated.

HOLDINGS

1. Appellants have not demonstrated error in the proposed assessment, which is based on information provided by the IRS.
2. Appellants have not demonstrated that the accuracy-related penalty should be abated.

DISPOSITION

FTB's action is sustained.

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Sheriene Anne Ridenour
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Sheriene Anne Ridenour
Administrative Law Judge

We concur:

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kenneth Gast
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Kenneth Gast
Administrative Law Judge

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

Date Issued: 11/17/2020

[3] Taxpayers may reduce or eliminate the understatement if they successfully demonstrate the following exceptions: (1) the taxpayers had substantial authority for their treatment of any item giving rise to the understatement; (2) the relevant facts affecting the item's tax treatment were adequately disclosed and there is a reasonable basis for the tax treatment of such item; or (3) the underpayment of any portion of the underpayment was due to reasonable cause and the taxpayers acted in good faith with respect to such portion of the underpayment. (IRC, §§ 6662(d)(2)(B), 6664(c)(1).)