

**OFFICE OF TAX APPEALS  
STATE OF CALIFORNIA**

In the Matter of the Appeal of:  
**S. MILAM**

) OTA Case No. 20056161  
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**OPINION**

Representing the Parties:

For Appellant: Daniel Davila, CPA

For Respondent: Eric R. Brown, Tax Counsel III

S. HOSEY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, S. Milam (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing a tax of \$8,199.00 and a late-filing penalty of \$2,049.75, plus applicable interest, for the 2017 tax year.

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

**ISSUES**

1. Whether appellant derived income from a California source that requires her to file a 2017 California nonresident return.
2. Whether appellant has established reasonable cause for failing to file a timely 2017 California nonresident return.

**FACTUAL FINDINGS**

1. Appellant was a California nonresident and resided in Texas in 2017. She has not filed a 2017 California income tax return.
2. Through its Integrated Non-Filer Compliance Program, FTB obtained a computer printout of appellant’s federal wage and income transcript (federal transcript) for the 2017 tax year showing that appellant received income of \$122,050 from Aspire Public

Schools and that Aspire Public Schools had reported such income to the Internal Revenue Service (IRS) on a federal Form 1099-MISC. The Form 1099-MISC from Aspire Public Schools reflects an Oakland, California address. Such information indicated to FTB that appellant had received sufficient income to trigger the 2017 California filing requirement.<sup>1</sup>

3. Subsequently, FTB issued a notice (Request) dated July 5, 2019, requesting that appellant file a 2017 California return, or explain why no return was required, by August 7, 2019.
4. When appellant neither filed a 2017 California return, nor supplied information showing that she did not have a 2017 California filing requirement, FTB issued a Notice of Proposed Assessment (NPA) dated September 30, 2019, based on the income reported by Aspire Public Schools. The NPA proposed additional tax of \$8,199 and a late-filing penalty of \$2,049.75, plus applicable interest, for the 2017 tax year.
5. Appellant filed a timely protest, asserting that the income of \$122,050 was earned by appellant's wholly-owned S corporation, Sweet Sharks, LLC, and that appellant, an individual, is not subject to California taxation. Appellant stated that the S corporation is incorporated<sup>2</sup> in Texas and that it did not have any employees in the State of California. Appellant also stated that Aspire Public Schools may have improperly filed a Form 1099-MISC under appellant's name. In addition, appellant asserted that the S corporation provided consulting services to Aspire Public Schools and that none of the consulting work was performed in California. Appellant did not provide any supporting documents (e.g., correspondence from the IRS accepting or processing a corrected Form 1099-MISC, etc.) with her protest letter.
6. After reviewing the matter, FTB affirmed the NPA in a Notice of Action.
7. Appellant then filed this timely appeal.
8. During the appeal proceedings, appellant provided copies of corrected Forms 1099-MISC, which state that during the 2017 tax year Aspire Public Schools made payments

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<sup>1</sup> The income of \$122,050 was reported under appellant's personal social security number. For the 2017 tax year, a single individual under age 65 years of age, with no dependents, had a California filing requirement if he or she had a California gross income of \$17,029 or a California adjusted gross income of \$13,623.

<sup>2</sup> The entity is named "Sweet Sharks, LLC," but it filed a federal Form 1120-S (U.S. Income Tax Return for an S Corporation). Sweet Sharks, LLC is a single member LLC, with appellant as the member/manager.

totaling \$122,050 to her wholly-owned S corporation Sweet Sharks, LLC and payments totaling \$0.00 to appellant.

9. In response, FTB provided a recent copy of appellant's federal transcript (dated December 17, 2020), which shows that as of December 17, 2020, the IRS had not received a corrected Form 1099-MISC from Aspire Public Schools.

### DISCUSSION

#### Issue 1: Whether appellant derived income from a California source that required her to file a 2017 California nonresident return.

California imposes a tax on the entire taxable income of a nonresident to the extent such income is derived from sources within this state. (R&TC, §§ 17041(b), 17951(a).) 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).) If a 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.” (R&TC, § 19087(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. (*Appeal of Bindley*, 2019-OTA-179P, 2019 WL 9047242.) 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); see also *Appeals of Bailey*, 92-SBE-001, 1992 WL 44503.) 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 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.)

Here, appellant failed to file a 2017 return, even after FTB issued a Request to her. As a result, FTB estimated appellant’s 2017 income based on appellant’s federal transcript for the

2017 tax year, which showed that appellant received income of \$122,050 from Aspire Public Schools and that Aspire Public Schools reported such income to the IRS on a federal Form 1099-MISC. FTB's use of such information to estimate appellant's taxable income is both reasonable and rational. (See *Giddo v. Commissioner* (1970) 54 T.C. 1530, 1533; *Andrews v. Commissioner*, T.C. Memo. 1998-316.) This evidence sufficiently links appellant with income-producing activity in California, and FTB's initial burden has therefore been met. (See *Rapp v. Commissioner*, *supra*, at p. 935.)

Once FTB has met its initial burden, the proposed assessment is presumed correct and the taxpayer has the burden of proving it to be wrong. (*Appeal of Bindley*, *supra*.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid.*) A taxpayer's failure to produce evidence that is within her control gives rise to a presumption that such evidence is unfavorable to her case. (*Appeal of Cookston*, 83-SBE-048, 1983 WL 15434.)

Appellant contends that the income of \$122,050 was earned by her wholly-owned S corporation, Sweet Sharks, LLC, and that appellant, an individual, is not subject to California taxation. Appellant states that Sweet Sharks, LLC is incorporated in Texas and that it did not have any employees in the State of California. Appellant also states that Aspire Public Schools improperly filed a Form 1099-MISC under appellant's name. Appellant further states that Sweet Sharks, LLC provided consulting services to Aspire Public Schools and that none of the consulting work was performed in California. In support, appellant provides corrected Forms 1099-MISC, which state that during the 2017 tax year Aspire Public Schools made payments totaling \$122,050 to Sweet Sharks, LLC and payments totaling \$0.00 to appellant.

Here, the corrected Forms 1099-MISC are not sufficient evidence, on their own, to demonstrate that the income of \$122,050 was earned by Sweet Sharks, LLC (and not earned by appellant, as an individual). First, FTB has provided a recent copy of appellant's federal transcript (dated December 17, 2020) showing that as of December 17, 2020, the IRS had not received a corrected Form 1099-MISC from Aspire Public Schools. Appellant has not shown that since then the IRS accepted or processed a corrected 1099-MISC.<sup>3</sup> Thus, it appears that Aspire Public Schools did not file the forms with the IRS and raises the question of whether the forms were produced by appellant to support her arguments on appeal. As the corrected Form

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<sup>3</sup> See Instructions for Payer on 1099-MISC, submitted by appellant on November 3, 2020, stating that the payor must file the form with the IRS.

1099-MISCs were not properly filed with the IRS by appellant’s employer, and there is no other evidence to substantiate that the forms correctly show that the services were provided by Sweet Sharks, LLC, we do not find them credible. Furthermore, appellant has not provided any contemporaneous evidence (e.g., a contract between Aspire Public Schools and Sweet Sharks, LLC, letters, emails, etc.) demonstrating that the underlying agreement for consulting services was between Aspire Public Schools and Sweet Sharks, LLC, such that the designation of appellant’s name as payee on the original Form 1099-MISC was incorrect. Contemporaneous evidence showing the connection between Aspire Public Schools and Sweet Sharks, LLC would support appellant’s contention; however, we have no credible evidence supporting this assertion, and appellant has not met her burden of proof.

In summary, appellant has not provided sufficient evidence showing that the income of \$122,050 was earned by Sweet Sharks, LLC (and not earned by appellant, as an individual).

#### Sourcing Income to California

Taxable income of nonresidents “shall be allocated and apportioned under rules and regulations prescribed by the [FTB].” (R&TC, § 17954.) California Code of Regulations, title 18, section 17951-4(c) provides income-sourcing provisions for when a nonresident’s business, trade, or profession is a sole proprietorship that conducts a unitary business with operations within and without California. Under this provision, when a sole proprietorship conducts a unitary business within and without California, its income is apportioned to California under the statutory apportionment provisions of the Uniform Division of Income for Tax Purposes Act (“UDITPA,” R&TC sections 25120-25139) that are applicable to corporations.

Regulation section 17951-4(c) can be broken down into five conditions that must be satisfied for a nonresident taxpayer to have California source income and a filing requirement: (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; (4) the taxpayer’s business must be conducted within and without California; and (5) the taxpayer must derive California source income.

1. *Appellant was a Nonresident of California.*

It is undisputed that appellant was a nonresident of California in 2017. Therefore, condition (1) has been met.

2. *Appellant was Conducting Business as a Sole Proprietorship.*

The term “sole proprietorship” is not defined in Regulation section 17951-4(c), or in the R&TC. A dictionary definition of a “sole proprietorship” is “[a] business in which one person owns all the assets, owes all the liabilities, and operates in his or her personal capacity.” (Black’s Law Dict. (10th ed. 2014).) For federal and California income tax purposes, a sole proprietorship neither files income tax returns nor pays income tax. Rather, the owner of the sole proprietorship reports all items of income on his or her individual tax return (i.e., on federal Schedule C) and must pay any taxes due.

As analyzed above, appellant has not provided sufficient evidence showing that the income of \$122,050 was earned by Sweet Sharks, LLC (and not earned by appellant, as an individual). Based on the evidence before us, we find that appellant conducted a consulting business as a sole proprietorship during 2017—and appellant has not demonstrated otherwise.

3. *Appellant was Carrying on a Unitary Business.*

The third requirement of Regulation 17951-4(c) is that appellant must be carrying on a unitary business. In the context of a sole proprietorship, a unitary business is a business, trade, or profession conducted both within and without the state, where the parts conducted within and without the state are not so separate and distinct from and unconnected to each other to be deemed separate businesses, trades, or professions. (*Appeal of Bindley, supra.*) Here, the evidence shows that appellant, as the sole proprietor of her business, performed services for Aspire Public Schools. She, thus, conducted a service business, which only she controlled and managed, and, as far as we can tell from the record, it was one interrelated and interdependent business employing and consuming the same resources. (*Appeal of Bindley, supra, at p. 7.*) Therefore, the third requirement has been met.

4. *Appellant was Carrying on a Business Within and Without California.*

The fourth requirement is that appellant must have been conducting business within and without California. The appeal record shows that appellant received California source income,

discussed below, from Aspire Public Schools, a California-headquartered company, for services rendered as a sole proprietor while she resided in Texas. Although appellant performed her services in Texas and apparently was never physically present in California during 2017, there is no statutory requirement that she must have a physical presence in California for the state to impose a tax. (*Appeal of Bindley, supra*, at p. 5.) In summary, we conclude that appellant was carrying on her business within and without California. Therefore, this requirement is met, and we will next analyze condition (5) to determine how much California source income appellant derived in 2017.

5. *California Source Income.*

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” UDITPA (R&TC, §§ 25120 to 25139) and the regulations thereunder. Thus, Regulation 17951-4(c)(2) treats businesses conducted through sole proprietorships the same as businesses conducted through corporations or other business entities subject to the UDITPA.

Multistate taxpayers engaged in a unitary business must apportion 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 this state by multiplying the business income by the sales factor. (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 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 that is sourced to California to the extent the purchaser of the service 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, market-based sales factor sourcing provisions 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, where 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 [i.e., appellant] and the taxpayer’s customer [i.e., Aspire Public Schools] 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, (A), we note that appellant has not produced copies of her books and records kept in the ordinary course of business, or a copy of the agreement between her business and Aspire Public Schools. Therefore, we cannot source appellant’s \$122,050 of gross receipts from Aspire Public Schools under this rule.

The question under the second cascading rule, (B), is whether we can reasonably approximate the location where Aspire Public Schools 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 [Aspire Public Schools] to the extent such information is available to [appellant].” (Cal. Code Regs., tit. 18, § 25136-2(b)(7).) Here, the Form 1099-MISC issued by Aspire Public Schools to appellant reflects an Oakland, California address. It therefore might be argued that, based on the available evidence, the record suggests that the benefit of the services can be reasonably approximated to have been received in California. However, the record does not otherwise reveal the location where Aspire Public Schools received the benefit of appellant’s services. Therefore, out of caution, we consider the next cascading rules.

Applying the third cascading rule, (C), if the location of the benefit cannot be determined under (A) or (B), 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. Here, the evidence in the appeal record does not show where Aspire Public Schools placed the order for appellant’s consulting services.

Under the final cascading rule, (D), if none of the other rules provide determination of the location of the state where the benefit was received, the customer’s billing address is used as the location where the benefit of the taxpayer’s services was received. Here, the Form 1099-MISC issued by Aspire Public Schools to appellant reflects an Oakland, California address. Based on the foregoing evidence, we find that the \$122,050 is properly sourced entirely to California. (See Cal. Code Regs., tit. 18, § 17951-4(c)(1), (2).)

Issue 2: Whether appellant has established reasonable cause for failing to timely file a 2017 California nonresident return.

California imposes a penalty for failing to file a return on or before the due date, unless the taxpayer shows that the failure is due to reasonable cause and not due to willful neglect. (R&TC, § 19131(a).) The late-filing penalty is calculated at 5 percent of the tax for each month or a fraction thereof that the return is late, with a maximum penalty of 25 percent of the tax. (*Ibid.*) To establish reasonable cause, the taxpayer must show that the failure to file timely returns occurred despite the exercise of ordinary business care and prudence, or that such cause

existed as would prompt an ordinary intelligent and prudent businessperson to have so acted under similar circumstances. (*Appeal of Head and Feliciano*, 2020-OTA-127P.)

When FTB imposes a penalty, the law presumes that the penalty was imposed correctly. (*Appeal of Xie*, 2018-OTA-076P.) The burden is on the taxpayer to establish reasonable cause for the failure to timely file. (*Ibid.*) To overcome the presumption of correctness attached to the penalty, the taxpayer must provide credible and competent evidence supporting a claim of reasonable cause; otherwise, the penalty cannot be abated. (*Ibid.*)

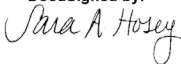
Here, FTB has not received appellant's 2017 return. Appellant has not provided any explanation that would demonstrate reasonable cause for failing to timely file a 2017 return, such as what steps, if any, she took to determine whether she had a filing requirement during the time-period the return became due. As discussed above, appellant had a filing requirement because she had sufficient California source income and met the filing threshold for 2017. Accordingly, appellant has not satisfied her burden of proving that her failure to timely file a return was due to reasonable cause.

HOLDINGS

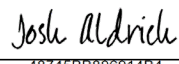
1. Appellant derived California source income of \$122,050 during the 2017 tax year and therefore she is required to file a 2017 California nonresident return.
2. Appellant has not established reasonable cause for failing to timely file a 2017 California nonresident return.

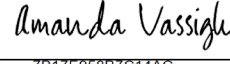
DISPOSITION

FTB’s action is sustained.

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 Sara A. Hosey  
 Administrative Law Judge

We concur:

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 Josh Aldrich  
 Administrative Law Judge

DocuSigned by:  
  
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 Amanda Vassigh  
 Administrative Law Judge

Date Issued: 9/27/2021