OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18011799
A. EDWARDS	)
	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant: Gene Weinstein,
M&G Business Services, LLC

For Respondent: Maria Brosterhous, Tax Counsel IV

J. LAMBERT, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, A. Edwards (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing to assess tax in the amount of $28,505.89, a late filing penalty of $7,126.47, a notice and demand (demand) penalty of $7,126.47, a filing enforcement cost recovery fee of $76, and interest, for the 2013 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 California source income from A.L.E. Production Services, Inc. (A.L.E.).
2. Whether the late filing penalty should be abated.
3. Whether the demand penalty should be abated.
4. Whether the filing enforcement cost recovery fee should be abated.

FACTUAL FINDINGS

1. Appellant, a nonresident of California, did not file a California income tax return for the 2013 tax year.
2. FTB received a 2013 California Schedule K-1 from A.L.E., a California S corporation, reporting that appellant, the sole shareholder, received a pro rata share of California source income of $411,133.[1]
3. A.L.E., through appellant, performed work as a subcontractor for Bellwether, Inc. (Bellwether), an Arizona corporation, which provided technical direction for commercial shows.[2] Appellant's duties included providing technical assistance, scheduling, budgeting, and management services for events.[3]
4. A 2013 "Sales by Customer Detail" schedule from A.L.E. includes a description of services provided to three customers during 2013: Instinctif; Peloton; and Bellwether. The schedule indicates the following service charges, totaling $467,566.05: (1) Instinctif: $16,388.52; (2) Peloton: $256,435.30; (3) Bellwether: $13,445.86; (4) BMC 2013 (charged through Bellwether): $1,400; and (5) Bellwether – Other: $179,896.37. Appellant provided 38 invoices totaling $467,566 to corroborate the customer detail schedule.
5. The schedule and invoices indicate services related to technical direction and various events, provided both within and without California.[4] For instance, invoices 2121, 2122, and 2116 indicate service charges related to an event in Anaheim, California (Citrix Anaheim) totaling $25,945.86. Invoices 2111, 2114, 2123, and 2126 indicate service charges related to an event in London, United Kingdom (Citrix London) totaling $54,355.54. Invoice 2120 indicates service charges related to an event in Las Vegas, Nevada (BMC 2013) totaling $1,400. The remaining invoices and charges indicate

[1] A.L.E. reported total gross receipts of $452,157 on its federal tax return.

[2] Bellwether was incorporated in Arizona in 2013, as indicated by documentation from the Arizona Corporation Commission.

[3] Appellant provides a 2019 letter from the president of Bellwether that states that A.L.E. performed services in the office of Bellwether in 2013.

[4] Peloton and Bellwether contracted with customers who held events and received benefits from appellant's services related to those events.

billing addresses located in Arizona for services contracted through Peloton and Bellwether.[5] Invoice 2148 indicates service charges for an event charged to a company with a billing address in New York, Instinctif, for $16,388.52.

6. FTB issued a Demand for Tax Return (Demand) to appellant on May 5, 2015, requiring appellant to, by the due date provided, file a return, provide a copy of the return if already filed, or explain why appellant was not required to file a return.[6]

7. When no response was provided, FTB issued an NPA on July 6, 2015. The NPA proposed to assess tax of $28,505.89, based on the $411,133 of California source income reported on the Schedule K-1 issued by A.L.E. The NPA also imposed a late filing penalty of $7,126.47, a demand penalty of $7,126.47, a filing enforcement cost recovery fee of $76, and applicable interest.

8. Appellant filed a protest in response to the NPA. FTB issued a Notice of Action on January 22, 2016, affirming the NPA. This timely appeal followed.

9. The Internal Revenue Service (IRS) issued a notice proposing an increase in appellant's tax for the 2013 tax year, based on an increase to his pro rata share from A.L.E from $237,956 to $401,778. However, a subsequent letter from the IRS stated that no tax was due because information was received from appellant that resolved the tax issue in question and the inquiry was closed.[7]

DISCUSSION

Issue 1: Whether appellant derived California source income from A.L.E.

R&TC section 18501 requires that every individual subject to the Personal Income Tax Law, whose gross income from all sources exceeds certain filing thresholds, 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." (R&TC, § 18501(a)(1)-(4).) R&TC

[5] Invoices 2130 and 2131 were billed through Peloton for events conducted for companies that appellant states are located in Georgia (i.e., Go Production, PBJ Productions), with service charges totaling $25,403.59.

[6] For the 2012 tax year, FTB issued a June 17, 2014 Demand and an August 25, 2014 Notice of Proposed Assessment (NPA). For the 2011 tax year, FTB issued a March 13, 2013 Request for Tax Return and a May 13, 2013 NPA.

[7] Appellant asserts that the pro rata share is $237,956 due to the deduction of expenses, which was accepted by the IRS.

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 entire taxable income of a nonresident to the extent it is derived from sources within this state. (R&TC, §§ 17041(b), (i), & 17951(a).)

If FTB proposes a tax assessment based on an estimate of income, its initial burden is to show why its assessment is reasonable and rational. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Bindley*, 2019-OTA-179P.) The taxing agency need only introduce some evidence linking the taxpayer with the unreported income. (See *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 is a reasonable and rational method of estimating taxable income. (See *Palmer v. Internal Revenue Service* (9th Cir. 1997) 116 F.3d 1309, 1313.) Once FTB has met its initial burden, its determination is presumed correct, and the taxpayer has the burden of proving it is wrong. (*Todd v. McColgan, supra*.)

Appellant failed to file a 2013 return. As a result, FTB estimated appellant's 2013 income based on the California source income of $411,133 reported by A.L.E. on its Schedule K-1. FTB's use of the Schedule K-1 to estimate appellant's taxable income is both reasonable and rational and sufficiently links appellant with income-producing activity in California. (See *Rapp v. Commissioner*, *supra*, 774 F.2d 932, 935.) Therefore, FTB's initial burden has been met and the burden of proof shifts to appellant to show error in FTB's determination.

Appellant asserts that he was not a California resident during 2013, and that he performed technical direction in Arizona for shows located both within the United States and internationally. Appellant contends that A.L.E. should have been terminated and that the Schedule K-1 was issued due to a clerical oversight. Appellant submitted an amended Schedule K-1 on appeal with the California source income zeroed out. Appellant provided a customer detail with a description of the services and charges, plus supporting invoices. The customer detail and invoices indicate services performed both within and without California.[8]

Taxable income of nonresidents shall be allocated and apportioned under rules and regulations prescribed by FTB. (R&TC, § 17954.) If a nonresident is a shareholder of an S corporation which carries on a unitary business, trade, or profession within and without the

[8] We note that the parties agree that A.L.E. had both California and non-California source income.

state, the amount of the nonresident's pro rata share of S corporation income derived from sources within this state shall be determined by apportioning the total business income of the S corporation in accordance with the apportionment rules of the Uniform Division of Income for Tax Purposes Act (the UDITPA, as codified in R&TC sections 25120-25139).[9] (See Cal. Code Regs., tit. 18, § 17951-4(f) & (d); *Appeal of The Metropoulos Family Trust*, *et al*., 2019-OTA-385P.) In *Butler Bros. v. McColgan* (1941) 17 Cal.2d 664, 678, affd. (1942) 315 U.S. 501, the California Supreme Court held that the existence of a unitary business may be established where there is unity of ownership, unity of operation, and unity of use (the three unities test). In *Edison California Stores, Inc. v. McColgan* (1947) 30 Cal.2d 472, 481, the Court held that a business was unitary if the operation of the business done within this state depended upon or contributed to the operation of the business outside the state (the contribution or dependency test). In *Appeal of Bindley*, *supra*, a unitary business was defined for purposes of Regulation 17951-4 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 as to be separate businesses, trades, or professions.

Here, appellant is the sole shareholder of an S Corporation, A.L.E., which carried on a unitary business. The customer detail and invoices corroborate the business was conducted both within and without California. The business was unitary, as the parts conducted within and without California were not so distinct from and unconnected to each other to be separate businesses. A.L.E. performed one service, technical direction of shows, and was controlled by a single shareholder, appellant. Accordingly, A.L.E. conducted a unitary business within and without California and, therefore, appellant's business income from A.L.E. is apportioned to California under the rules of the UDITPA. For taxable years beginning on or after January 1, 2013, all business income of an apportioning trade or business, other than an apportioning trade or business described in R&TC section 25128(b), shall 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

[9] California Code of Regulations, title 18, section (Regulation) 17951-4(f) states that, if a nonresident is a shareholder of an S corporation which carries on a unitary business, trade or profession within and without this state, the amount of the nonresident's pro rata share of S corporation income derived from sources within this state shall be determined in the same manner as if the S corporation were a partnership, which includes applying the UDITPA, as described under Regulation 17951-4(d)(1).

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.)

R&TC section 25136(a)(1) states that sales from services are assigned to California to the extent the purchaser of the service (i.e., the taxpayer's customer) receives the benefit of the service in California. (See also Cal. Code Regs., tit. 18, § 25136-2(c).) Where, as here, a corporation or other business entity is the taxpayer's customer, the location of the benefit of the service is determined by applying cascading rules, in the following order, such that if the location cannot be determined under one rule, we proceed to the next: (1) the taxpayer-customer contract, or the taxpayer's books and records kept in the normal course of business;[10] (2) reasonable approximation; (3) where the taxpayer's customer placed the order for the service; and (4) the taxpayer's customer's billing address. (Cal. Code Regs., tit. 18, § 25136-2(c)(2)(A)-(D).)

In this case, A.L.E.'s records indicate some of the locations where its customers received the benefit of the services, which are the locations where events held by customers, or customers of customers, were provided with technical direction or other services by A.L.E. Invoices 2121, 2122, and 2116 indicate services related to an event in Anaheim, California, totaling $25,945.86. Therefore, under the first sourcing method above, we presume that the location of the benefit of those services was in California based on A.L.E.'s books and records kept in the normal course of its business.

However, A.L.E.'s records also indicate the benefit of services in locations outside of California. Invoices 2111, 2114, 2123, and 2126 indicate services related to an event in London, United Kingdom, totaling $54,355.54. Invoice 2120 indicates services related to an event in Las Vegas, Nevada, totaling $1,400. Therefore, A.L.E.'s books and records show that customers received the benefit of appellant's services outside of California, in London and Las Vegas.

The location of the events where the benefit presumably was received is not always specifically indicated by A.L.E.'s books and records, so for those income items we will proceed to the next method and determine if the location can be reasonably approximated. According to Regulation 25136-2(b)(7), "reasonably approximated" means that, considering all sources of information other than the terms of the contract and the taxpayer's books and records kept in the

[10] To the extent the location of the benefit of the services is indicated by the first cascading rule, a rebuttable presumption is created which may be overcome based on a preponderance of evidence. (Cal. Code Regs., tit. 18, § 25136-2(c)(2)(A).)

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 the customer to the extent such information is available to the taxpayer. In making a reasonable approximation of the location of the benefit of services, *Appeal of Bindley*, *supra*, examined both public records from the California Secretary of State to show that the taxpayer's customers were both registered and located in California, and contracts which listed California addresses for the customers.[11] (See *Appeal of Bindley*, *supra*.) In addition, it was conceded by appellant in that case that the customers were California limited liability companies. (*Ibid*.)

In making a reasonable approximation of the location of the benefit of the services, we examine sources other than A.L.E.'s books and records kept in the normal course of business. A document from the Arizona Corporation Commission shows that Bellwether was incorporated in Arizona in 2013. In addition, a 2019 letter from the president of Bellwether states that A.L.E. performed services in the office of Bellwether in 2013. In this case, A.L.E.'s invoices also indicate an Arizona address for Bellwether, which corroborates the documentation in the record and appellant's assertions that Bellwether is located in Arizona. Therefore, based on the above examination of information from various sources, we can reasonably approximate that the location of the benefit of appellant's services to Bellwether was in Arizona.

As discussed above, there is no basis for concluding that the services benefited customers in California under any of the cascading rules described above, other than for services provided for an event in Anaheim. We do not have the customer contracts; however, appellant provided invoices showing that A.L.E.'s customers, or the customers' customers, were provided services for an event in Anaheim. Other than those invoices, the books and records that have been produced do not suggest that customers received the benefit of any of A.L.E.'s services in California. We do not know the location from which appellant's customers placed the orders. However, with respect to the remaining invoices, including those for Peloton and Instinctif, the billing addresses on the invoices all are outside of California. Therefore, we conclude that the services benefited appellant's customers outside of California.

In summary, we find that the location of the benefit of A.L.E.'s services was outside of California, other than for the $25,945.86 of invoices related to an event in Anaheim. Other than

[11] In *Appeal of Bindley*, *supra*, it was found that the customers were "headquartered" and registered in California.

those invoices, there is a lack of evidence connecting the benefit of A.L.E.'s services to California.

Accordingly, to compute appellant's sales factor, we use $25,945.86 as the numerator, and use total gross receipts from everywhere of $452,157, as reported by A.L.E. on its federal tax return, as the denominator. This results in a sales factor apportionment percentage of roughly 5.73 percent ($25,945.86 ÷ $452,157). We use appellant's pro rata share of $237,956 as the amount of business income, as it was the amount accepted by the IRS, and FTB does not specifically dispute that the IRS accepted that appellant's pro rata share is $237,956. Multiplying business income of $237,956 by a sales factor of 5.73 percent results in California source income of $13,654.49. Because appellant has California source income and substantial gross income from all sources that exceeds the California filing thresholds, he has a filing requirement for the 2013 tax year and must pay tax on his California source income. Accordingly, FTB's proposed assessment of additional tax is modified to reflect a revised California source income of $13,654.49.

Lastly, we note that FTB argues that because the evidence shows that a *portion* of FTB's original determination is correct, the *entirety* of FTB's determination should be upheld unless and until appellant files a California return. This argument, as stated by FTB, is as follows:

> Appellant may not use the appeals process to avoid filing a tax return for which he is legally obligated. Instead, if appellant disagrees with respondent's assessment or any portion thereof, he must file a tax return.

FTB further alleges that:

> It is not appropriate to create the burden of an audit on either party without appellant first filing a return. In view of the information respondent had at the time of the assessment, it is reasonable and rational to determine that appellant received California sourced income during the year at issue and has a filing obligation. As such, respondent has met its initial burden and the burden is now on appellant to file a tax return or establish he has no duty because he has no California sourced income.

FTB's position would have us contravene the California Taxpayers' Bill of Rights, which provides, in pertinent part, as follows:

> The Legislature further finds and declares that the purpose of any tax proceeding between the Franchise Tax Board and a taxpayer is the determination of the taxpayer's correct amount of tax liability. It is the intent of the Legislature that, in

> furtherance of this purpose, the Franchise Tax Board may inquire into, and shall allow the taxpayer every opportunity to present, all relevant information pertaining to the taxpayer's liability.

(R&TC, § 21002.) Thus, we may not disregard evidence and argument that would reduce the proposed deficiency simply because appellant has not filed a tax return for the year at issue,[12] and nothing in R&TC section 19087 requires a contrary conclusion.

Issue 2: Whether the late filing penalty should be abated.

California imposes a penalty for failing to file a valid 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.) 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. (R&TC, § 19131(a).) To establish reasonable cause, the taxpayer must show that the failure to file a timely return occurred despite the exercise of ordinary business care and prudence, or that such cause existed as would prompt an ordinarily intelligent and prudent businessperson to have so acted under similar circumstances. (*Appeal of Head and Feliciano*, 2020-OTA-127P.)

Appellant argues that he does not have a California filing requirement and has not filed a return. However, appellant's records indicate he received California source income and gross income from all sources in an amount sufficient to require him to file in California. As appellant's own records indicate California source income, he should have taken steps to determine whether he may have a California filing requirement. Taxpayers do not exercise ordinary business care and prudence when they fail to acquaint themselves with California tax law requirements. (*Appeal of Diebold, Inc*. (83-SBE-002) 1983 WL 15389.) Therefore, appellant has not shown reasonable cause for failing to timely file a return. However, as stated above, the California source income is reduced to $13,654.49 and the computation for the late filing penalty must be adjusted accordingly.

Issue 3: Whether the demand penalty should be abated.

California imposes a penalty for the failure to file a return or to provide information upon FTB's Demand to do so, unless the taxpayer shows that the failure to respond to the Demand is

[12] Of course, it may be to a taxpayer's advantage to file a nonresident return in order to lessen his or her liability by establishing entitlement to a different filing status, itemized deductions, or an other state tax credit for taxes paid in the taxpayer's state of residence on income taxed by California.

due to reasonable cause and not due to willful neglect. (R&TC, § 19133.) With respect to individual taxpayers, FTB will only impose a demand penalty if the taxpayer fails to respond to a current Demand and FTB issued an NPA under the authority of R&TC section 19087(a) after the taxpayer failed to timely respond to a Request for Tax Return or a Demand at any time during the four taxable years preceding the year for which the current Demand is being issued. (Cal. Code Regs., tit. 18, § 19133(b)(1)-(2).) FTB issued a 2013 Demand to appellant on May 5, 2015, but appellant did not provide a response. Therefore, we examine whether the prerequisites of Regulation 19133 are satisfied. For the 2012 tax year, FTB issued a June 17, 2014 Demand and an August 25, 2014 NPA. For the 2011 tax year, FTB issued a March 13, 2013 Request for Tax Return and a May 13, 2013 NPA. Therefore, the 2011 and 2012 NPAs were not issued "during" the four tax years prior to 2013. As a result, the prerequisites of Regulation 19133 are not satisfied, and the demand penalty is abated.

Issue 4: Whether the filing enforcement cost recovery fee should be abated.

R&TC section 19254(a)(2) requires FTB to impose a filing enforcement cost recovery fee in the event a taxpayer fails to file a return within 25 days after FTB mails a Demand to the taxpayer. There is no reasonable cause exception or other exception that permits the abatement of this fee. (See *Appeal of Wright Capital Holdings, LLC*, 2019-OTA-219P.) Here, the fee was properly imposed after appellant failed to timely file a 2013 tax return in response to the Demand. Accordingly, appellant is liable for the filing enforcement cost recovery fee.

HOLDINGS

1. Appellant derived California source income from A.L.E. of $13,654.49.
2. The late filing penalty is not be abated.
3. The demand penalty is abated.
4. The filing enforcement cost recovery fee is not abated.

DISPOSITION

FTB's action is modified to reflect revised California source income of $13,654.49 and to abate the demand penalty. Additionally, appellant's late filing penalty is correspondingly recomputed and reduced based on the revised California source income. FTB's action is otherwise sustained.

DocuSigned by:
Josh Lambert
CB1E7DA37831416...
Josh Lambert
Administrative Law Judge

We concur:

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

DocuSigned by:
E. Scott Ewing
2D8DE82EB65E4A6...
Elliott Scott Ewing
Administrative Law Judge

Date Issued: 2/1/2021