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2022 – OTA – 145
Nonprecedential

**OFFICE OF TAX APPEALS**

**STATE OF CALIFORNIA**

| In the Matter of the Appeal of: | ) OTA Case No. 19044655 |
|---|---|
| **T. BASS** | ) |

# OPINION

Representing the Parties:

For Appellant: Joseph F. Fragnoli, CPA

For Respondent: Mira V. Coutinho, Tax Counsel

A. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, T. Bass (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing additional tax of $2,502.00, a late filing penalty of $625.50, plus interest, for the 2016 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 Mulroy Insurance Agency, LLC (Mulroy).
2. Whether appellant has established reasonable cause for failing to timely file a 2016 return.

## FACTUAL FINDINGS

1. During the 2016 tax year, appellant was a California nonresident who resided in Tennessee. Also during that tax year, appellant rendered consulting services to Mulroy, a California limited liability company (LLC), while residing in Tennessee. Mulroy issued appellant a Form 1099-MISC which reported that appellant received $59,950 as non-employee compensation for his services during the 2016 tax year. On appellant's

2016 federal Schedule C, he reported gross receipts of $207,423 and a net profit of $143,425. He also stated "insurance sales and consulting" as his principal business or profession.

2. FTB sent appellant a Request for Tax Return, requiring appellant to file a 2016 return or explain why he was not required to file one.
3. After receiving no response, FTB issued a Notice of Proposed Assessment (NPA) with estimated income of $59,950 (appellant's entire 2016 income from Mulroy), a standard deduction of $4,129,[1] and taxable income of $55,821. The NPA proposed a total tax liability of $2,502.00 and a late filing penalty of $625.50, plus interest.
4. Appellant thereafter sent FTB his response to the Request and indicated that he received total gross income from all sources of $149,787, and supported himself in 2016 by "self employed [sic] business."
5. When FTB inquired about the service or activity appellant performed for Mulroy, he responded, in part, by attaching a letter written by Mulroy's managing partner that stated appellant provided consulting services to Mulroy while working remotely from Tennessee, he was not an employee of Mulroy, and his "primary modes of communication" during 2016 were through "Web-based services like 'Skype' and 'Go to Meeting,' as well as phone conferencing, texts and email."
6. FTB issued a Notice of Action, affirming the NPA.
7. This timely appeal followed.

## DISCUSSION

Issue 1. Whether appellant derived California source income from Mulroy.

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

[1] FTB applied the standard deduction for a single individual with no dependents. For the 2016 tax year, a single individual under age 65 with no dependents realizing California gross income of $16,597 or a California adjusted gross income of $13,278 was required to file a California income tax return.

"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."

When FTB makes a proposed assessment of additional tax based on an estimate of income, FTB's initial burden is to show why 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 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*.)

<u>California Taxation of Nonresidents and Application of California Code of Regulations, title 18, section (Regulation) 17951-4</u>

California imposes a tax on the taxable income of a nonresident, such as appellant, to the extent it is derived from sources within this state. (R&TC, §§ 17041(b) & (i), 17951(a).) Gross income of nonresidents from sources within and without California "shall be allocated and apportioned under rules and regulations prescribed by [FTB]." (R&TC, § 17954.)

Regulation 17951-4 provides income sourcing provisions applicable to a nonresident's business, trade, or profession. Under Regulation 17951-4(c), when a sole proprietorship conducts a unitary business within and without California, its business income is apportioned to California under 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*.)

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Here, there is no dispute that appellant was a California nonresident during the 2016 tax year. Likewise, the evidence establishes that appellant conducted his business as a sole proprietor. This is corroborated by appellant's federal Schedule Con which he reported that he was carrying on an insurance sales and consulting business. Thus, the first and second requirements of Regulation 17951-4(c) have been met.

The third requirement of Regulation 17951-4(c) is that appellant must be carrying on a unitary business, trade, or profession. In the context of a sole proprietorship, 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 pp. 5-6, original italics.) Here, the evidence shows that appellant, as the sole proprietor of his business, was a consultant for Mulroy.[2] Mulroy hired appellant for his consulting services, which he rendered in his capacity as a consultant, i.e., an owner of a sole proprietorship. "He, thus, conducted a one service business, which only he controlled and managed," and as far as we can tell from the record, it was "but 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.

The final requirement is that appellant must have been conducting business within and without California. The record shows that appellant received income from Mulroy, a California-based LLC, for services rendered as a sole proprietor. Although appellant argues that he did not conduct his business within California because he was never physically present in this state during 2016, the statute does not require a physical presence in California for the state to impose a tax. (*Appeal of Bindley*, *supra*, at p. 5.) Consequently, because appellant performed services in Tennessee and derived California source income, as discussed next, from a company located in California, we conclude that appellant was carrying on his business within and without California.

[2] We note that the gross income appellant reported on his Schedule C included income he received from other insurance companies, in addition to Mulroy.

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 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 by multiplying the business income only by the sales factor.[3] (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 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 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, 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 [i.e., appellant] and the taxpayer's customer [i.e., Mulroy] or the taxpayer's books and records kept in the normal course of business, notwithstanding the billing

[3] 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).)

> 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.

Here, we are unable to apply the first cascading rule under subparagraph (A) because the record does not include any contract between appellant and Mulroy or appellant's books and records, and Mulroy's California billing address is irrelevant in the analysis.

Under the second cascading rule, we can reasonably approximate the location where Mulroy 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 [Mulroy] to the extent such information is available to [appellant]." (Cal. Code Regs. tit. 18, § 25136-2(b)(7).) Public records from the California Secretary of State provided by FTB show that Mulroy is registered and located in California. Appellant also provided his training and services to Mulroy's employees in California. Appellant did not present any evidence establishing that Mulroy had locations or employees outside of California or that he provided these services to Mulroy's employees outside of California. Based on this evidence, we find that it was both reasonable and rational for FTB to conclude that Mulroy received the benefit of appellant's services within California.

Appellant argues that this case is distinguishable from *Appeal of Bindley*, *supra*, because the taxpayer there produced a tangible product, i.e., a screenplay, for a California company, and "it was known in advance that the product [in *Appeal of Bindley*] was to benefit a California company and could not be produced any other way." Appellant reasons that here, in contrast, Mulroy received the benefit of his services in Tennessee because "[t]he product, if you will, was delivered and consumed from Tennessee and not California" apparently because "Mulroy sought out [appellant] to provide consulting services" and Mulroy "went to [Tennessee], via telephone, Skype, or in physical presence to retain the services." However, *Appeal of Bindley* does not find that the taxpayer's income was California source income because the taxpayer was required to deliver a tangible product. *Appeal of Bindley* applied the rules for the assignment of sales other than sales of tangible personal property (i.e., services and intangibles) under R&TC section 25136 (and the regulations thereunder) and not the rules for the assignment of sales of tangible personal property under R&TC section 25135 (and the regulations thereunder). "[P]hysical presence does not determine whether [a taxpayer] had income derived from California, but rather it is determined by where the benefits of [the taxpayer's] services were received." (*Appeal of Bindley*, *supra*, at p. 9.)

Our analysis does not end here, however, because appellant's Schedule C, provided to FTB during the protest, shows appellant had gross receipts totaling $207,423 (not just the $59,950 received from Mulroy) from his insurance consulting and sales business, and we have no reason to believe appellant conducted more than one unitary business. Thus, it appears appellant's income from Mulroy was only a portion of his total unitary business consulting income. Therefore, under Regulation 17951-4(c)(1) and (2), we must apportion appellant's total unitary business income to determine his taxable California source income and not simply source the income from Mulroy to California, as FTB has done.

To compute appellant's sales factor, his California receipts from Mulroy of $59,950 is the numerator, and his total everywhere receipts of $207,423 is the denominator (i.e., $59,950/$207,423). This results in a sales factor apportionment percentage of roughly 28.9 percent. Multiplying appellant's total net unitary business income of $143,425 by a sales factor of 28.9 percent results in California source income of $41,453, not $59,950 as computed by FTB.

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Issue 2. Whether appellant has established reasonable cause for failing to timely file a 2016 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 (after reduction for amounts paid on or before the date prescribed for payment and by the amount of any credit against the tax which may be claimed on the return). (*Ibid*.) To establish reasonable cause, the taxpayer must show that the failure to timely file a return occurred despite the exercise of ordinary business care and prudence, or that circumstances existed that would cause a prudent businessperson with ordinary intelligence to have acted in the same way under similar circumstances. (*Appeal of Head*, 2020-OTA-127P.)

When FTB imposes a penalty, the burden is on the taxpayer to establish reasonable cause for the failure to timely file. (*Appeal of Xie*, 2018-OTA-076P.) 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*.)

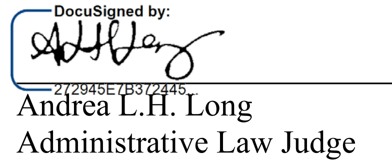
As we stated above, the California source income is reduced to $41,453 and the computation for the late filing penalty must be adjusted accordingly. However, appellant has not offered any explanation that would demonstrate reasonable cause for failing to timely file a return. Accordingly, appellant has not satisfied his burden of proving that his failure to timely file a return was due to reasonable cause and not willful neglect. Therefore, appellant is not entitled to abatement of the late filing penalty.

## HOLDINGS

1. Appellant derived only $41,453 of California source income from Mulroy.
2. Appellant did not establish reasonable cause for the failure to timely file a 2016 return. However, the amount at issue must be recomputed based on the modified California source income.

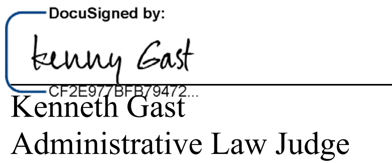
## DISPOSITION

FTB's assessment is modified such that $41,453 of appellant's income is California source income. Additionally, appellant's late filing penalty is correspondingly recomputed and reduced based on the revised California source income. Otherwise, FTB's assessment is sustained.

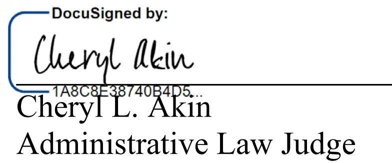


Andrea L.H. Long
Administrative Law Judge

We concur:



Kenneth Gast
Administrative Law Judge



Cheryl L. Akin
Administrative Law Judge

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