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OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

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

OPINION ON PETITION FOR REHEARING

Representing the Parties:

For Appellant: Joseph F. Fragnoli, CPA

For Respondent: Mira V. Coutinho, Tax Counsel

A. LONG, Administrative Law Judge: On November 16, 2020, the Office of Tax Appeals (OTA) issued an Opinion modifying respondent Franchise Tax Board's (FTB) action in this matter such that only $41,453 of appellant's income is California source income.

FTB filed a petition for rehearing (PFR) under California Code of Regulations, title 18, (Regulation) section 30604 based on two grounds: insufficiency of the evidence and contrary to law.[1]

OTA may grant a rehearing when one of the following grounds is met and materially affects the substantial rights of the party seeking a rehearing: (1) an irregularity in the proceedings that occurred prior to the issuance of the Opinion and prevented fair consideration of the appeal; (2) an accident or surprise that occurred during the appeals proceeding, which ordinary caution could not have prevented; (3) newly discovered, relevant evidence, which the filing party could not have reasonably discovered and provided prior to issuance of the written Opinion; (4) insufficient evidence to justify the written Opinion; (5) the Opinion is contrary to

[1] FTB states in its petition for rehearing that there was an error in law. An error in law applies in situations where the Panel has, as a matter of law, committed an error during the appeals process (e.g., where the Panel has made an erroneous ruling to admit or reject evidence, or failed to consider or respond to a party's request to file an additional brief, obtain an extension of time, or to return the matter to the oral hearing calendar). (Cal. Code Regs., tit. 18, § 30604(b).) Here, FTB is not arguing that there was an "error in law" during the course of the proceedings, such as an order or procedural ruling that is erroneous as a matter of law. FTB is, in fact, arguing that the Opinion is "contrary to law," pursuant to Regulation section 30604(a)(5). Accordingly, we address that issue instead.

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law; or (6) an error in law in the appeals hearing or proceeding. (Cal. Code Regs., tit. 18, § 30604(a)(1)-(6); *Appeal of Do*, 2018-OTA-002P.) Regulation section 30604 is based upon the provisions of the Code of Civil Procedure (CCP) section 657, case law pertaining to the operation of CCP section 657, as well as the language of the statute itself, and are persuasive authority in interpreting the provisions contained in this regulation.

<u>Contrary to Law</u>

To find that the opinion is against or contrary to law, we need not reweigh the evidence, but must find that the opinion is "unsupported by any substantial evidence." (*Appeal of Graham and Smith*, 2018-OTA-154P, citing *Sanchez-Corea v. Bank of America* (1985) 38 Cal.3d 892, 906.) This requires a review of the opinion to indulge "in all legitimate and reasonable inferences" to uphold the opinion. (*Sanchez-Corea v. Bank of America*, *supra*, at p. 907.) The relevant question is not over the quality or nature of the reasoning behind the opinion, but whether the opinion can be valid according to the law. (*Appeal of NASSCO Holdings, Inc.* (2010-SBE-001) 2010 WL 5626976.)

FTB argues that the Opinion applied the wrong burden of proof standard. FTB asserts that once it met its initial burden, the assessment is presumed correct and that appellant has the burden of proving it wrong. FTB cites to *Honeywell, Inc. v. State Board of Equalization* (1982) 128 Cal.App.3d 739, 744, for the proposition that the taxpayer must produce evidence to establish the proper amount of tax. FTB argues that appellant's federal tax return (Form 1040) does not meet this burden of proof because "it does not amount to 'evidence to establish the proper amount of tax' " pursuant to *Honeywell, Inc. v. State Board of Equalization*, *supra*.

When a taxpayer fails to file a return, FTB may estimate a taxpayer's net income from "any available information" and assess the amount of tax, interest, and penalties due. (R&TC, § 19087.) 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.) Federal courts have held that 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 and refuses to cooperate in the ascertainment of his or her income, FTB is given "great latitude" in estimating income. (*Appeals of Bailey* (92-SBE-001) 1976 WL 44503; *Appeal of Tonsberg* (85-SBE-034) 1985 WL 15812.) Once FTB's

initial burden is satisfied, FTB's determination is presumed to be correct and the taxpayer has the burden of proving error. (*Appeal of GEF Operating, Inc.*, 2020-OTA-057P.)

Although we agree with FTB that the burden of proof shifted to appellant once FTB met its initial burden, this is not outcome determinative. The presumption applies to issues of fact and not to questions of law. (Cal. Code Regs., tit. 18, § 30219(a); *Appeal of Von Housen Motors* (82-SBE-036) 1982 WL 11714 ["While it is well settled that [FTB's] determinations as to issues of fact are presumed to be correct, and that the burden of providing the evidence necessary to upset such findings rests with the taxpayer, it is equally well established that no such presumption is appropriate as to questions of law.].) In *Appeal of Boca Land Company* (31-SBE-014) 1931 WL 776, the Board of Equalization (BOE) determined its duty was to determine the correct amount of tax based on the law. "Otherwise, our function would resolve itself merely into the determination of a dispute between [the tax agency] and a taxpayer, both of whom may be wrong." (*Ibid*.)

Here, the Panel was faced with a mixed question of law and fact; that is, whether appellant's income from Mulroy was taxable by California and, if so, whether the assessment correctly apportioned the income to California. The relevant facts in this case were not in dispute. The Panel agreed with FTB that appellant's services fell within the parameters of Regulation section 17951-4. But the Panel determined that FTB misapplied the law by failing to apportion appellant's California income. This, in turn, resulted in an incorrect assessment of tax.

To tax a nonresident of California, the law limits the taxation of nonresidents to income that is derived from sources within this state. (R&TC, § 17041.) FTB's own regulations dictate how to determine business income derived from sources within this state from a nonresident sole proprietor conducting a unitary business within and without of state—by applying the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA). (Cal. Code Regs., tit. 18, § 17951-4(c)(2).) FTB was unable to show that it applied those provisions here. As such, it was well within the duties of the Panel to determine the correct amount of tax by apportioning appellant's income as the regulations dictate based on the record before them. Therefore, the Opinion is not contrary to law.

<u>Insufficiency of the Evidence</u>

To make a finding based on an insufficiency of evidence to justify the opinion, we must find that, after weighing the evidence in the record, including reasonable inferences based on that

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evidence, the Panel clearly should have reached a different determination. (*Appeals of Swat-Fame, Inc., et al.*, 2020-OTA-045P.) We may review conflicting evidence, weigh its sufficiency, consider credibility of witnesses, and draw reasonable inferences from the evidence presented in the underlying appeal. (See *Valdez v. J. D. Diffenbaugh Co.* (1975) 51 Cal.App.3d 494, 512.)

FTB argues that the Opinion went outside the scope of the issue that the parties briefed; that is, the issue was limited to whether appellant had a filing requirement, and the Opinion should not have included a recalculation of FTB's assessment. FTB also argues that appellant's Form 1040 is unreliable and as such, the Panel's recalculation of FTB's assessment based on the Form 1040 information is also unreliable. We address each issue in turn.

Tax Return Requirement

FTB argues that the issue in this appeal was limited to whether appellant derived California source income from Mulroy and, thus, the Opinion should have limited its conclusion to a finding that appellant did have California source income. Put another way, FTB contends that "[t]he issue on appeal was simply whether Appellant had California source income such that he was required to file a California income tax return." Additionally, FTB asserts that tantamount to its mission to ensure the fair administration of California's tax laws in a self-compliance-based system is the filing of a valid and accurate tax return by the taxpayer. FTB argues that, by modifying appellant's assessment without the filing of a return, OTA condones appellant's refusal to file a return despite the existence of a filing requirement, and it undermines FTB's ability to ensure the fair administration of the tax code with respect to all similarly situated taxpayers.

This appeal arose from FTB's issuance of a Notice of Action on a proposed deficiency assessment of additional tax, penalty, and interest, which OTA has jurisdiction to hear and adjudicate pursuant to R&TC section 19045. Based on this appeal, OTA's jurisdiction was limited to determining the correct amount of appellant's California personal income tax liability for the appeal years. (*Appeals of Dauberger, et al*. (82-SBE-082) 1982 WL 11759.) Although the Panel agreed with FTB that appellant had California source income, this conclusion does not answer whether FTB's proposed *assessment* is correct. Moreover, just as OTA has no power to remedy any other real or imagined wrongs that taxpayers believe they may have suffered by the hands of FTB, OTA equally has no power to remedy a taxpayer's refusal to file a tax return. (See *ibid.*) As such, FTB's desire for OTA to force a taxpayer to file a return is not within the

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purview of OTA's appeal process; rather, as laid out in R&TC section 19045 and Regulation section 30103, the assessment itself is what can be appealed and reviewed by OTA.

Additionally, a taxpayer must only prove error in FTB's determination to rebut FTB's presumption of correctness. (See *Todd v. McColgan*, *supra*, 89 Cal.App.2d 509, 514 [holding that FTB has the initial burden of showing that its assessment is reasonable and rational, after which the burden shifts to the taxpayer to show error in the assessment].) Appellant must show error in FTB's determination by a preponderance of evidence. (Cal. Code Regs., tit. 18, § 30219(c).) Appellant could rebut FTB's presumption of correctness by providing credible, competent, and relevant evidence. (*Appeal of GEF Operating, Inc*., *supra*.) The law does not require that appellant file a tax return as a preliminary matter for OTA to determine the correct amount of appellant's California source income.

Scope of the Appeal

FTB argues that there is insufficient evidence to justify OTA's Opinion because neither party briefed the computation issue, which resulted in misleading and incomplete information. OTA's Opinion, FTB asserts, went outside the scope of the issue. FTB contends that had the issue of sales factor been raised during the briefing process, it "would have provided evidence in support or opposition to the Schedule Cs provided in protest."

FTB frames its opposition of the Panel's recalculation of appellant's tax liability as if the Panel's sales factor analysis occurred sua sponte. As previously discussed, FTB's assessment is based on Regulation section 17951-4, which dictates the application of UDITPA provisions to determine a taxpayer's business income derived from sources within this state. FTB's failure to address all parts of its own regulation does not require the Panel to request additional briefing from FTB. Indeed, the fact that appellant did not address sales factor or apportionment does not preclude FTB from raising this relevant issue in its own briefings when FTB relies on Regulation section 17951-4 as the basis of its assessment. Accordingly, FTB's failure to address sales factor or the apportionment rules without prompting by the Panel or appellant, when it had several opportunities to do so, is not a basis for a rehearing.

Finally, FTB states that had it briefed the sales factor issue, it "would have provided evidence in support or opposition to the Schedule Cs provided in protest." FTB's continual lack of certainty about how it would have briefed the issue falls short of proving that the missed opportunity to provide an explanation materially affected FTB's rights. The mere possibility that

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FTB would have disagreed with the Panel's use of the Schedule Cs undercuts any claim that the Panel clearly should have reached a different determination. (*Appeals of Swat-Fame, Inc., et al.*, *supra*.) FTB has failed to show that its allegations of insufficient evidence materially affected FTB's rights.

Reliability of Appellant's Federal Return

FTB argues that appellant's Form 1040 is potentially inaccurate, and therefore the Panel's recalculation of tax based on Form 1040 is also inaccurate. FTB now provides with its PFR appellant's federal account transcript to compare with appellant's federal return, which shows that there are differing values accepted by the IRS for (1) the filing status, (2) adjusted gross income, and (3) tax per return. FTB also points out that appellant provided two Schedule Cs but the Panel only used one of them in its sales factor calculation. FTB argues that if appellant conducted only one unitary business, OTA should have used both Schedule Cs in its calculation.

The OTA Regulations (Cal. Code Regs, tit. 18, § 30000 et seq.) define evidence as "any information contained in the written record or oral hearing record that the panel may consider when deciding an appeal." (Cal. Code Regs., tit. 18, § 30102(h).) Rules relating to evidence contained in the California Evidence Code and the California Code of Civil Procedure do not apply to any proceedings before OTA, but the Panel may rely on the Evidence Code when evaluating the weight to give the evidence. (Cal. Code Regs., tit. 18, § 30214(e).) When an appellant waives his or her right to an oral hearing, as is the case here, the appeal is limited to the written record, which includes "statements and arguments in the briefs and other documents filed with OTA …." (Cal. Code Regs., tit. 18, § 30102(w)(1); see also Cal. Code Regs., tit. 18, § 30209(b).)

FTB submitted into evidence appellant's Form 1040 that appellant initially provided to FTB during protest. FTB provided this document in the appeal before OTA to show that appellant's "filing of a Schedule C, Profit or Loss from Business, as part of his federal return, shows he was carrying on a business generally. (Exhibit F, page 7.)" Based upon FTB's own reliance and submission of this document, it was reasonable for the Panel to infer that the document itself was reliable.

The discrepancies between the federal account transcript and appellant's submitted Form 1040 may have been apparent to FTB during the appeal, but FTB did not make it known to

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the Panel. FTB gave no indication that the information it provided was unreliable. In fact, FTB's own actions of submitting the document into the record to rely on the information on the return justified the Panel's belief that Form 1040 was in fact reliable. Thus, this discrepancy does not show that the Panel clearly should have reached a different conclusion, and therefore does not support a granting of a rehearing based on the insufficiency of the evidence standard.

Regarding the recalculation of appellant's tax liability, there was sufficient evidence in the record to justify the recalculation. We cannot review appellant's Form 1040 in a vacuum but instead, after weighing the evidence, must be convinced from the entire record, including reasonable inferences therefrom, that the Panel clearly should have reached a different result. (*Appeals of Swat-Fame, Inc., et al.*, *supra*.) The Panel was faced with two pieces of evidence to reconcile in order to determine appellant's tax liability: appellant's Form 1040 and appellant's Wage and Income Transcript.

Appellant's Form 1040 included two Schedule Cs. The first Schedule C lists gross receipts of $207,423, and the second lists gross receipts of $299. The Form 1099-MISC at issue, reported by Mulroy, lists non-employee compensation of $59,950. According to appellant's Wage and Income Transcript, the total of all appellant's Form 1099-MISCs non-employee compensation is $154,422, and the total of all Form W-2s compensation is $299. Appellant reported on his return $53,599 more than what was reported on his Wage and Income Transcript. Because the first Schedule C likely encompasses the amount at issue (i.e., $59,950 reported by Mulroy), the Panel used the first Schedule C in its recalculation of appellant's taxable liability. It is unclear whether the $299 listed on the second Schedule C is included in the amount listed on the first Schedule C. However, the combined total reported on the Wage and Income Transcript of $154,721 is less than what is reported on the first Schedule C, and thus, it was reasonable for the Panel to infer that the first Schedule C includes the amount listed on the second Schedule C and any additional amounts that were not reported on the Wage and Income Transcript. Based on the evidence provided in the record, we do not find any conflicting evidence that leads us to believe that the Panel should have arrived at a different determination. (See *Bray v. Rosen*, (1959) 167 Cal.App.2d 680, 683.)

In sum, we are not convinced from the entire record, including reasonable inferences derived from FTB's evidence, that the Panel should have reached a different calculation. FTB argues that because there is a possibility that the Panel's calculation is wrong, the Opinion cannot

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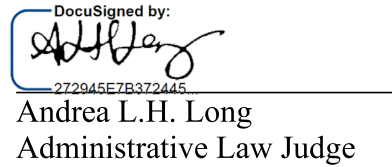
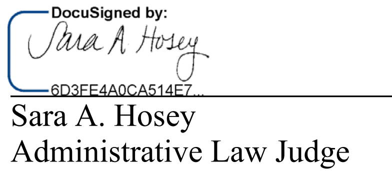
be upheld. However, this uncertainty does not establish that the Panel should have reached a different result. (See *Appeals of Swat-Fame, Inc., et al.*, *supra*.) Based on the foregoing, we find that FTB has not shown grounds exist for a new hearing as required by the authorities referenced above, and FTB's PFR is hereby denied.

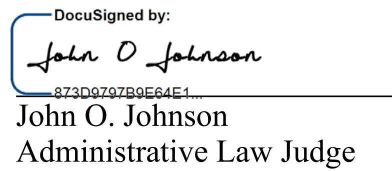


Andrea L.H. Long
Administrative Law Judge

We concur:



Sara A. Hosey
Administrative Law Judge



John O. Johnson
Administrative Law Judge

Date Issued: 4/19/2022