

**OFFICE OF TAX APPEALS
STATE OF CALIFORNIA**

In the Matter of the Appeal of:) OTA Case No. 19034436
L. KLEIN AND)
J. KLEIN)
_____)

OPINION

Representing the Parties:

For Appellants: Jacob Hade, Tax Appeals Assistance
Program (TAAP)
McKenna Clark, TAAP¹

For Respondent: Joel Smith, Tax Counsel III

For Office of Tax Appeals: Michelle Huh, Tax Counsel

T. STANLEY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, L. Klein and J. Klein (appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing additional tax of \$4,581, and applicable interest, for the 2014 taxable year.

Office of Tax Appeals Administrative Law Judges Teresa A. Stanley, Cheryl L. Akin, and Sheriene Anne Ridenour held a virtual, oral hearing for this matter on March 23, 2022. At the conclusion of the hearing, the record was closed, and this matter was submitted for a decision.

ISSUE

Have appellants established error in FTB’s proposed assessment of additional tax, which is based on federal adjustments made by the IRS?

¹ Appellants filed their opening and additional briefs. Subsequently, Jessica Robles and Michael Hallock of TAAP each filed a reply brief on appellants’ behalf.

FACTUAL FINDINGS

1. During the 2014 taxable year, appellants had rental properties and reported operating two businesses, Green Earth Trading Company (Green Earth) and Klein Rocks, as separate sole proprietorships. On their 2014 federal tax return, appellants reported rental property income and expenses on Schedule E, Green Rocks income and expenses on Schedule C1, and Klein Rocks income and expenses on Schedule C2.
2. Appellants acquired a business license for Klein Rocks on February 23, 2015. Klein Rocks was established in order to “harvest and sell rocks and boulders” for drought resistant landscaping. Appellants created an undated business plan for Klein Rocks. On or about April 6, 2015, appellants placed an ad on Craigslist, advertising the sale of “Landscape Boulders/Rock for Decorative Landscaping.”
3. Appellants provided evidence of six sales of rocks and boulders. Of these, five sales were made in 2014 totaling \$2,976.45, all sold between January 3, 2014, and June 24, 2014. No sales were made after Klein Rocks acquired its business license in 2015.
4. Appellants sold the property on Salmon Falls Road, the location where Klein Rocks was licensed, on October 12, 2015.
5. Appellants timely filed a 2014 joint California tax return, which FTB accepted.
6. Subsequently, the IRS adjusted appellants’ federal account. Specifically, the IRS: (1) allowed additional rental property repairs; (2) disallowed deductions for repairs and other expenses reported for Green Earth; (3) reduced Klein Rocks’ gross receipts to zero; and (4) disallowed all expense deductions reported for Klein Rocks.
7. Based on the information provided by the IRS, FTB made corresponding adjustments to appellants’ California taxable income to the extent applicable under California law. FTB issued appellants a Notice of Proposed Assessment (NPA) dated March 27, 2018, and proposed to assess additional tax of \$4,581, plus interest.

8. Appellants protested the NPA asserting that they started a business in 2014 to sell drought resistant rocks and boulders extracted from a property on Salmon Falls Road.²
9. The IRS audit report shows the adjustments to appellants' taxable income. The IRS audit report states that Klein Rocks did not meet the guidelines for carrying on a trade or business within the meaning of Internal Revenue Code (IRC) section 162, and the claimed expenses were for capital improvements.³
10. On February 12, 2019, FTB issued a Notice of Action affirming its NPA.
11. Appellants timely filed this appeal.

DISCUSSION

R&TC section 18622(a) provides that if the IRS changes or corrects any item required to be shown on a federal tax return, a taxpayer must report each change or correction within six months of the final federal determination, or as required by FTB, and concede the accuracy of the determination or state wherein it is erroneous. If the federal determination increases the taxpayer's federal personal income tax liability, the determination will also increase the taxpayer's California personal income tax liability to the extent California law follows federal law. (See *Ordlock v. Franchise Tax Board* (2006) 38 Cal.4th 897, 901.) It is well settled that a deficiency assessment based on a federal audit report is presumptively correct, and a taxpayer bears the burden of proving that the determination is erroneous. (*Appeal of Gorin*, 2020-OTA-018P.) In the absence of credible, competent, and relevant evidence showing that FTB's determination is incorrect, the determination must be upheld. (*Appeal of Valenti*, 2021-OTA-093P.)

Deductions from gross income are a matter of legislative grace, and a taxpayer has the burden of proving entitlement to the deductions claimed. (*New Colonial Ice Co. v. Helvering*

² Appellants initially challenged all the adjustments but at the oral hearing, appellants withdrew their dispute of the Green Earth adjustments. The adjustments to appellants' Schedule E rental properties were in their favor. Thus, this Opinion will only address adjustments to the Klein Rocks federal Schedule C2. Appellants also initially claimed that FTB had made a contract with them because an FTB representative told them that they had a zero balance on their 2014 tax account. Appellants did not address that argument at the oral hearing, and even if they had it would fail because appellants are unable to show that they detrimentally relied on advice given by FTB. (See *Appeal of Lecompte* (89-SBE-025) 1989 WL 137369.)

³ The IRS audit report also advises appellants that the claimed expenses could be added to their basis in the Salmon Falls Road property, such that it would decrease their capital gain when the property was sold. Appellants did sell the property in 2015 but did not increase their basis to account for capital expenditures on the property. Appellants did not file amended returns after receiving the IRS audit report.

(1934) 292 U.S. 435; *Appeal of Dandridge*, 2019-OTA-458P.) To carry the burden of proof, the taxpayer must point to an applicable statute and show by credible evidence that the deductions claimed come within its terms. (*Appeal of Jindal*, 2019-OTA-372P.)

Appellants assert that they are entitled to the disallowed expense deductions for Klein Rocks because they were carrying on a business of extracting and selling rocks and boulders for drought resistant, decorative landscaping. Appellants state that most of the claimed expenses for 2014 were incurred in an effort to clear debris and to excavate to access the rocks. When asked why so much excavation was required to remove rocks and boulders from the property, appellants responded that excavation was needed in order to pick the rocks up off the ground and to place them on buyers' properties.

FTB counters that appellants contracted for capital improvements on a single-family site. FTB asserts that the improvements to the property were for personal reasons, such as grading for a driveway and building pad. As support, FTB points to documents submitted by appellants showing that they had obtained permits for grading for a driveway connecting to a single-family house pad. FTB also contends that appellants had no real profit motive, and that no checks, invoices, permits, or other documentation was in the name of Klein Rocks, but rather referenced appellants themselves.

Under federal law, a taxpayer is allowed to deduct “all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.”⁴ (IRC, § 162(a).) Only expenses related to carrying on the trade or business are deductible. (See *Higgins v. Commissioner* (1941) 312 U.S. 212, 217.) The definition of “trade or business” is not found in the IRC, but the U.S. Supreme Court has provided a well-known rule of thumb, which is “to be engaged in a trade or business, [a] taxpayer must be involved in the activity with continuity and regularity and ... the primary purpose for engaging in the activity must be for income or profit.” (*Commissioner v. Groetzinger* (1987) 480 U.S. 23, 35.) To qualify as an allowable deduction, the expense must “(1) be ‘paid or incurred during the taxable year,’ (2) be for ‘carrying on any trade or business,’ (3) be an ‘expense,’ (4) be a ‘necessary’ expense, and (5) be an ‘ordinary’ expense.” (*Commissioner v. Lincoln Savings & Loan Assn.* (1971) 403 U.S. 345, 352.)

⁴ California generally conforms to IRC provisions for itemized deductions for individuals and corporations through R&TC section 17201.

Pursuant to IRS section 183(a), taxpayers may not deduct expenses for an activity that is not engaged in for profit. Treasury Regulation section 1.183-2(b) provides a nonexclusive list of objective factors to be considered in deciding whether an activity is engaged in for profit, although no one factor is determinative. (*Allen v. Commissioner* (1979) 72 T.C. 28, 33-34.) The factors are: (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or the taxpayer's advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar activities; (6) the taxpayer's history of income or loss with respect to the activity; (7) the amount of occasional profits, if any, which are earned; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or recreation are involved. (Treas. Reg. § 1.183-2(b); *Appeal of Walters v. Commissioner*, T.C. Memo. 2022-17.)

Here, the IRS audit report shows that the IRS determined that Klein Rocks did not meet the definition of carrying on a trade or business within the meaning of IRC section 162. As a result, the IRS disallowed all the income and expenses for Klein Rocks in its final determination. FTB followed the federal determination, and adjusted Klein Rocks' gross receipts to zero and disallowed its cost of goods sold and all of its claimed business expenses.⁵ On appeal, appellants have provided copies of Klein Rocks' business plan, a Craigslist advertisement, sales receipts, check images, receipts, invoices, credit card statements, and work agreements, which appellants contend show that Klein Rocks was engaged in a trade or business and incurred the claimed business expenses during its operation in the 2014 taxable year. OTA analyzes this evidence to determine whether Klein Rocks was carrying on a trade or business under the nonexclusive factors of Treasury Regulation section 183-2(b).

The manner in which the taxpayer carries on the activity

Appellants did not conduct the activities at issue here in a business-like manner. Appellants did not separately account for their alleged business activities. They made no journals detailing income and expenses for the business. Appellants did not have a separate business bank account. Invoices, checks, and receipts are mostly in appellants' personal names

⁵ Per IRC section 183(b)(2) where an activity is not engaged in profit, deductions relating to such activity are only allowable to the extent of the gross income from that activity for the taxable year. Removing all income and expense reported on Schedule C2 for Klein Rocks has the same effect as allowing deductions up to the amount of the gross receipts reported, as both result in \$0 net gain or less for this activity.

and not in the name of Klein Rocks. Some of the deductions claimed by appellants seem to be personal, unrelated to either running a rock extraction business, or related to capital improvements, e.g., two receipts for Coors Light, garden items including a “veggie vine,” donuts, Safeway sandwiches for one to six people, hydrangea and bougainvillea vines, and a metal detector. This factor favors a finding that appellants were not carrying on a trade or business.

The expertise of the taxpayer or the taxpayer’s advisors

There is no evidence that appellants sought the help of any advisor on how to run a company to extract and sell moss rocks and boulders. Appellants testified they had not operated a similar business previously. While appellants had a business plan, it did not provide any analysis of potential revenues or expected business expenses. Appellants’ business plan does not show how or when appellants believed Klein Rocks would or could generate a net profit. Appellants have not shown that they had the requisite expertise to run Klein Rocks as a business. This factor weighs against a finding that appellants were carrying on a trade or business.

The time and effort expended by the taxpayer in carrying on the activity

Appellants testified that Klein Rocks was their only business during 2014 and that they worked at the business 5 days a week and at least 40 hours a week. While there is no direct evidence in the record that this is untrue, OTA believes that such a work schedule would have generated more than five sales over the course of a year. Additionally, the mere fact that appellants worked at the Salmon Falls Road property, or for the benefit of the property, is not dispositive of the question of whether they were working at a business for profit or working to make capital improvements. This factor is neutral.

The expectation that assets used in the activity may appreciate in value

Neither party disputes that the Salmon Falls Road property, being real estate, was expected to appreciate in value. Once again, however, that expectation does not show that appellants’ activities and the expenses incurred on the property were related to a trade or business or were instead contributing to an increase in the value of the property as a capital asset. This factor is neutral.

The success of the taxpayer in carrying on other similar activities

Appellants testified that they had no experience in carrying on any similar activities in the past. This factor favors a finding that appellants were not engaged in carrying on a trade or business.

The taxpayer's history of income or loss with respect to the activity

Appellants made their first 2014 sale of moss rocks on January 3, 2014, selling \$60 worth of moss rocks, before appellants pulled their first permit for grading on the property on January 14, 2014. The permit was expressly for grading a “single family site.” Appellants made four more sales in 2014 on March 23, 2014, April 13, 2014, June 9, 2014, and June 24, 2014. No more sales occurred in 2014, bringing total gross receipts to \$2,976.45 for the taxable year. Moreover, appellants did not make any sales in 2015 after obtaining a business license for Klein Rocks and placing a single advertisement on Craigslist to sell rocks and landscaping material. The bulk of the expenses claimed by appellants were incurred in and after June 2014, yet it appears appellants made no attempts to seek a profit relative to the large amount of expenses incurred. The dearth of sales and sales activities belie appellants’ alleged profit motive. Therefore, this factor weighs in favor of a finding that appellants were not engaged in a trade or business.

The amount of occasional profits, if any, which are earned

The amount and frequency of occasional profits earned from the activity may also indicate a profit objective. (*Walters v. Commissioner, supra.*) An opportunity to earn a substantial, ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated. (Treas. Reg. § 1.183-2(b)(7).) Appellants have not presented evidence of any opportunity for substantial profits once their improvements were complete. FTB contends that the real value of the improvements was in obtaining profits from the sale of the improved real property, i.e., capital improvements. Although appellants made no sales after obtaining a business license in 2015 and placing one Craigslist ad, they claim that is because a neighbor “made [them] an offer that [they couldn’t] refuse.” Although escrow did not close until October 12, 2015, appellants do not explain why they made no attempts to make any sales whatsoever between June 24, 2014, and the date the property sold more than a year later.

Therefore, this factor weighs in favor of a finding that appellants' activities constituted capital improvements to increase the value of their property for sale rather than an ongoing trade or business.

The financial status of the taxpayer

OTA was not provided information related to appellants' financial status. This factor is therefore neutral.

Whether elements of personal pleasure or recreation are involved

Appellants testified that they did not purchase the property to use it for their personal pleasure or recreation. Furthermore, appellants testified that they did not use the property at any time while they owned it. This factor favors appellants' position that they were using the property to carry on a trade or business.

Conclusion

Weighing each of the factors above, OTA concludes that appellants have failed to establish that they were engaged in an ongoing trade or business. Rather, the evidence shows that: (1) appellants made little to no effort to sell rocks or boulders, (2) they in fact sold only a minimal amount, (3) they did not have or try to obtain the expertise necessary to run such a business, (4) appellants were improving the property for a single-family residence pad and a driveway, and (5) appellants did in fact sell the property for a profit shortly after the improvements were completed.


Based on the foregoing, appellants have not established error in the final federal determination or FTB's assessment based on the final federal determination disallowing the income and expenses of Klein Rocks for the 2014 taxable year.

HOLDING


Appellants have not established error in FTB’s proposed assessment of additional tax, which is based on federal adjustments made by the IRS.


DISPOSITION

FTB’s action is sustained.

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Teresa A. Stanley
Administrative Law Judge

We concur:

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Cheryl L. Akin
Administrative Law Judge

DocuSigned by:

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Sheriene Anne Ridenour
Administrative Law Judge

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