

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:
J. SKINNER

) OTA Case No. 20046122
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)
)

OPINION

Representing the Parties:

For Appellant: Tom Skinner, Attorney

For Respondent: Christopher T. Tuttle, Tax Counsel III
Maria Brosterhous, Tax Counsel IV

For Office of Tax Appeals: David Kowalczyk, Tax Counsel

J. LAMBERT, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, J. Skinner (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing assessments of additional tax totaling \$459,239,¹ late filing penalties totaling \$114,809.75,² and accuracy-related penalties totaling \$91,787.80,³ plus applicable interest, for the 2007 to 2010 tax years.

Office of Tax Appeals Administrative (OTA) Law Judges Josh Lambert, Cheryl L. Akin, and Andrea L.H. Long, held an oral hearing via videoconference for this matter on

¹ FTB originally proposed to assess additional tax of \$60,507, \$62,833, \$131,489, and \$204,410 for tax years 2007, 2008, 2009, and 2010, respectively. On appeal, FTB revises the amounts of the proposed additional tax to \$45,941, \$47,869, \$98,770, and \$154,575 for tax years 2007, 2008, 2009, and 2010, respectively.

² FTB originally proposed to assess late filing penalties of \$15,126.75, \$15,708.25, \$32,872.25, and \$51,102.50, for tax years 2007, 2008, 2009, and 2010, respectively. On appeal, FTB revises the amounts of the late filing penalties to \$11,485.25, \$11,967.25, \$24,692.50, and \$38,643.75 for tax years 2007, 2008, 2009, and 2010, respectively.

³ FTB originally proposed to assess accuracy-related penalties of \$12,101.40, \$12,566.60, \$26,297.80, and \$40,822 for tax years 2007, 2008, 2009, and 2010, respectively. On appeal, FTB revises the amounts of the accuracy-related penalties to \$9,188.20, \$9,573.80, \$19,754, and \$30,915 for tax years 2007, 2008, 2009, and 2010, respectively.

February 23, 2022. At the conclusion of the hearing, the record was closed, and this matter was submitted for decision.

ISSUES

1. Whether appellant has established error in FTB's revised proposed assessments for the 2007 through 2010 tax years.
2. Whether the late filing penalties should be abated for the 2007 through 2010 tax years.
3. Whether the accuracy-related penalties should be abated for the 2007 through 2010 tax years.

FACTUAL FINDINGS

1. FTB did not have a record of appellant filing tax returns for the 2007 through 2010 tax years. FTB received information showing that appellant may have had sufficient income to prompt a filing requirement for those years and issued Demands for Tax Return (Demands) for 2007 through 2010.
2. After appellant did not respond to the Demands, FTB issued Notices of Proposed Assessments (NPAs) for 2007 through 2010 proposing to assess tax, penalties, and interest. Appellant did not protest the NPAs and the NPAs became final.
3. After the NPAs became final, the IRS audited and adjusted appellant's 2007 to 2010 federal tax returns based on an analysis of appellant's bank deposit information.
4. FTB received information from the IRS on September 8, 2016, that federal adjustments had been made and issued subsequent revised NPAs on May 7, 2018, for tax years 2007 to 2010⁴ based on those adjustments.⁵
5. For 2007, FTB increased appellant's gross receipts or sales by \$657,266 and disallowed meal and entertainment expenses of \$213, other expenses of \$650, and car and truck

⁴ This second set of NPAs indicate that, sometime after the initial set of NPAs, appellant filed California tax returns for the years at issue that reported negative taxable income. Appellant filed federal tax returns on June 24, 2014; April 11, 2014; April 7, 2014; and March 13, 2014, for tax years 2007, 2008, 2009, and 2010, respectively.

⁵ For each tax year, FTB also proposed to adjust appellant's self-employment tax deduction and itemized deduction limitation based on the federal adjustments.

- expenses of \$2,117. FTB proposed to assess additional tax of \$60,507, an accuracy-related penalty of \$12,101.40, and a late filing penalty of \$15,126.75.⁶
6. For 2008, FTB increased appellant's gross receipts or sales by \$681,327 and disallowed meal and entertainment expenses of \$544, other expenses of \$766, car and truck expenses of \$5,280, and real estate losses of \$4,337.⁷ FTB proposed to assess additional tax of \$62,833, an accuracy-related penalty of \$12,566.60, and a late filing penalty of \$15,708.25.
 7. For 2009, FTB increased appellant's gross receipts or sales by \$1,349,104 and disallowed other expenses of \$588, car and truck expenses of \$4,793, real estate losses of \$3,930, and a net operating loss carryforward of \$4,337. FTB proposed to assess additional tax of \$131,489, an accuracy-related penalty of \$26,297.80, and a late filing penalty of \$32,872.25.
 8. For 2010, FTB increased appellant's gross receipts or sales by \$2,054,902 and disallowed meal and entertainment expenses of \$628, other expenses of \$988, car and truck expenses of \$5,116, and real estate losses of \$3,610. FTB proposed to assess additional tax of \$204,410 of, an accuracy-related penalty of \$40,882, and a late filing penalty of \$51,102.50.
 9. Appellant timely protested the NPAs for 2007 through 2010.
 10. FTB issued Notices of Action affirming the NPAs for 2007 through 2010, which appellant timely appealed to OTA.
 11. Subsequently, the IRS revised its federal assessments for 2007 through 2010 after audit reconsideration. Appellant provided documentation to the IRS which included two months of bank statements to show that he used personal credit cards to pay for clients' business expenses. The IRS agreed to estimate appellant's business expenses as 23.3 percent of the additional business gross receipts assessed for 2007 through 2010.⁸

⁶ The adjustments to gross income and expense deductions for each year were made to appellant's Schedules C.

⁷ The adjustments to real estate losses for this and subsequent years were made to appellant's Schedules E.

⁸ These adjustments also revised appellant's federal self-employment tax, self-employment tax deduction, and itemized deduction limitations for 2007 through 2010.

12. Based on the federal adjustments, FTB agrees to make similar revisions to its proposed assessments.
13. For 2007, FTB agrees to reduce appellant's additional tax to \$45,941, the accuracy-related penalty to \$9,188.20, and late filing penalty to \$11,485.25.
14. For 2008, FTB agrees to reduce appellant's additional tax to \$47,869, the accuracy-related penalty to \$9,573.80, and the late filing penalty to \$11,967.25.
15. For 2009, FTB agrees to reduce appellant's additional tax to \$98,770, the accuracy-related penalty to \$19,754, and the late filing penalty to \$24,692.50.
16. For 2010, FTB agrees to reduce appellant's additional tax to \$154,575, the accuracy-related penalty to \$30,915, and the late filing penalty to \$38,643.75.

DISCUSSION

Issue 1: Whether appellant has established error in FTB's revised proposed assessments for the 2007 through 2010 tax years.

A taxpayer shall concede the accuracy of federal changes to a taxpayer's income or state where the changes are erroneous. (R&TC, § 18622(a).) FTB's determination based on a federal adjustment to income is presumed correct and the taxpayer bears the burden of proving FTB's determination is erroneous. (*Appeal of Valenti*, 2021-OTA-093P.) FTB's determination must be upheld in the absence of credible, competent, and relevant evidence showing that its determination is incorrect. (*Appeal of Chen and Chi*, 2020-OTA-021P.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Bracamonte*, 2021-OTA-156P.)

Gross income means all income from whatever source derived, including income derived from a business, unless the items of income are specifically excluded by law. (Internal Revenue Code (IRC), § 61(a)(2); Treas. Reg. § 1.61-1(a); R&TC, § 17071.) A reasonable reconstruction of income using bank deposits is presumed correct, and the taxpayer has the burden of disproving the computation. (*Appeal of Durlester* (77-SBE-116) 1977 WL 4106.)

There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. (IRC, § 162(a); R&TC, § 17201.) An income tax deduction is a matter of legislative grace and the burden of showing the right to the claimed deduction is on the taxpayer. (*Appeal of Dandridge*, 2019-OTA-458P.) The fact that it may be difficult, if not impossible, for the taxpayer to substantiate his or her

claimed deductions does not relieve the taxpayer of this burden. (*Appeal of Giese* (86-SBE-016) 1986 WL 22687.)

If there is sufficient evidence indicating the taxpayer incurred a deductible expense, but the precise amount of the deduction to which the taxpayer is otherwise entitled cannot be determined, a court or other finder of fact may make an approximation of the amount of the deduction, bearing heavily against the taxpayer whose inexactitude is of the taxpayer's own making. (*Cohan v. Commissioner* (2d Cir. 1930) 39 F.2d 540, 543-544.) However, there must be some basis upon which an estimate may be made. (*Vanicek v. Commissioner* (1985) 85 T.C. 731, 743.)

Appellant contends that FTB's proposed assessments are improper because they are based upon incomplete information.⁹ However, the record does not indicate that the assessments were improper. In this case, the FTB's proposed assessments were based on federal adjustments to appellant's gross income and expense deductions for the same tax years. The record indicates that these federal adjustments were based on appellant's records, such as his bank deposits, and the IRS allowed business expense deductions based on appellant's available records, including his credit card statements. As noted above, reasonable reconstruction of income using bank deposits is presumed correct, and the taxpayer has the burden of disproving the computation. (*Appeal of Durlister, supra.*) Additionally, it appears that the IRS applied *Cohan v. Commissioner, supra*, to estimate appellant's allowable expense deductions based on the limited documentation appellant had available and presented to the IRS. Therefore, FTB's proposed assessments based on the federal adjustments, are presumed correct, and appellant has the burden to show that adjustments should be made. (*Appeal of Valenti, supra.*)

Appellant also argues for a deviation from the IRS assessments on which FTB based its proposed assessments and contends that the IRS assessments are incorrect. Appellant asserts that the unreported income includes income which was dispersed to third parties as part of his check cashing business. Appellant contends that he charged between one and two percent of each check amount, and that the remaining amount was returned to the holder of the check. Appellant provides a spreadsheet indicating deposits made between November and December of 2010 and

⁹ Appellant also contends that the NPAs are untimely. However, appellant did not notify FTB of the federal changes for 2007 through 2010 within six months of the final federal determination date, as required by R&TC section 18622(a). Therefore, FTB's NPAs issued on May 7, 2018, are not barred by the statute of limitations as they were issued within four years from the date the IRS notified FTB of the federal changes on September 8, 2016. (See R&TC section 19060(b).)

noting that many of the deposited checks were made out to third parties as opposed to appellant, personally.

Appellant further contends that he made short-term business loans that were subsequently reimbursed, and that these reimbursements are also included in unreported income assessed by the IRS and FTB. Appellant asserts that he made purchases from wholesale stores on behalf of a restaurant business owner. Appellant provides some documentation from two wholesale stores indicating purchases made during the years at issue. Appellant also provides his credit card statements for December 2009, through February 2010, indicating purchases made, which include purchases from the wholesale stores. Appellant asserts that documentation to support his contentions has been difficult to obtain. Appellant states that he was unable to obtain bank records because banks only keep records for a certain period, which has been exceeded in this case, and provides evidence of his requests made to the banks for the records. Appellant also asserts that he was not provided with the calculations of how the IRS assessments were determined.

At the hearing, appellant introduced witness testimony from a bank teller who testified that appellant frequently deposited third party checks at her bank. She testified that appellant came in two-to-three times per week and sometimes more frequently. She testified that appellant had an agreement on file to deposit third-part checks because he is a business owner and had a business account. Finally, she testified that appellant deposited the checks and, though the checks could not be cashed outright, he would make withdrawals to take the money out and get change for the business. A customer of appellant's check cashing business also testified that he would bring expense checks for his business to appellant's establishment and would cash them with appellant who charged two percent of the check amount. He also testified that the checks were in his name and not appellant's.

Finally, appellant testified as to the nature of the business. Appellant testified that he was not the business owner, but a signee on the business account that could cash checks, to clarify the statements made by the bank teller witness. As to the short-term business loans, appellant testified that he allowed the business owner to use his credit cards to purchase food and beverages for his restaurant business, and that the business owner would pay appellant back within a few days. Appellant testified that his credit card statements match up with the deposited check amounts. Appellant also testified that the IRS did not see when the credit card payments

were paid because it did not subpoena the e-bill system which he used to make the credit card payments or review the debits from appellant's bank account. Appellant testified that he provided sufficient documentation, including evidence of the third-party checks, and that it is unreasonable to believe that hundreds of people would, without reason, give him these checks that add up to a substantial amount of money.

While the evidence indicates that appellant's check cashing and business loan activities likely generated nontaxable deposits, including loan repayments/reimbursements, and business expense deductions, appellant has not provided evidence to establish that the amounts were not already included in the revisions made by the IRS and FTB. Appellant provides no guidance as to how the deposit and purchase amounts in the documentation provided on appeal should be used in computing further adjustments. The documentation provided, such as the spreadsheet showing deposits, is only for two months in 2010, and appellant admittedly did not keep contemporaneous records and cannot obtain supporting bank records. Without further evidence, there is no basis to determine the extent to which the additional income originated from the check cashing and loan businesses or from other sources.

During federal audit reconsideration, the IRS made an adjustment for 2007 through 2010 allowing 23.3 percent of appellant's unreported gross receipts or sales as business expenses, and FTB similarly made revisions based on this federal adjustment. However, as noted by appellant, there is no evidence as to the calculation of 23.3 percent adjustment and to what extent the IRS already incorporated adjustments based on the documentation appellant provides in this appeal. While appellant testified that the 23.3 percent reduction was entirely attributable to appellant's loan business and did not include any adjustments for appellant's check cashing business, appellant provides no evidence establishing that the IRS adjustments were based only on the loan business and does not provide guidance to show the extent to which the IRS adjustments relate to specific amounts on the documentation provided in this appeal. As a result, there is no basis to determine if and to what extent any further adjustments should be made, and the record includes insufficient documentation to establish a basis for further adjustments. Therefore, appellant has not shown error in FTB's revised proposed assessments of tax.

Issue 2: Whether the late filing penalties should be abated for the 2007 through 2010 tax years.

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).) When FTB imposes a late filing penalty, it is presumed to have been correctly imposed, and the burden of proof is on the taxpayer to show that reasonable cause exists to abate the penalty. (*Appeal of Xie*, 2018-OTA-076P.) To overcome the presumption of correctness, the taxpayer must provide credible and competent evidence supporting a claim of reasonable cause. (*Ibid.*) To establish reasonable cause, the taxpayer must show the failure to timely file a return occurred despite the exercise of ordinary business care and prudence. (*Appeal of Friedman*, 2018-OTA-077P.)

Appellant does not argue, and the record does not establish, reasonable cause for the failure to timely file the tax returns. Therefore, appellant has not shown that the revised late filing penalties should be abated.

Issue 3: Whether the accuracy-related penalties should be abated for the 2007 through 2010 tax years.

IRC section 6662, incorporated by R&TC section 19164, provides for an accuracy-related penalty of 20 percent of the applicable underpayment. IRC section 6662(b) provides, in relevant part, that the penalty applies to the portion of the underpayment attributable to any substantial understatement of income tax. A substantial understatement of tax exists if the understated amount exceeds the greater of 10 percent of the tax required to be shown on the return or \$5,000. (IRC, § 6662(d)(1)(A).) An “understatement” is defined as the excess of the amount of tax required to be shown on the return for the tax year over the amount of the tax imposed which is shown on the return, reduced by any rebate. (IRC, § 6662(d)(2).) The accuracy-related penalty shall not be imposed with respect to any portion of an underpayment if it is shown that there was reasonable cause for the portion and the taxpayer acted in good faith with respect to the portion. (IRC, § 6664(c)(1).)

Appellant’s understatements of tax exceed the greater of 10 percent of the tax required to be shown on the return or \$5,000. Accordingly, the penalties are properly imposed based on substantial understatements of tax. Appellant does not provide any argument or evidence to show reasonable cause and good faith with respect to the underpayments or that any other

exceptions to the penalty apply.¹⁰ Accordingly, appellant has not shown that the revised accuracy-related penalties should be abated.

HOLDINGS

1. Appellant has not established error in FTB's revised proposed assessments for the 2007 through 2010 tax years.
2. The late filing penalties are not abated for the 2007 through 2010 tax years.
3. The accuracy-related penalties are not abated for the 2007 through 2010 tax years.

DISPOSITION

FTB's actions are modified as conceded on appeal but are otherwise sustained.¹¹

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Josh Lambert

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Josh Lambert
Administrative Law Judge

We concur:

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Cheryl L. Akin

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Cheryl L. Akin
Administrative Law Judge

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Andrea L.H. Long

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Andrea L.H. Long
Administrative Law Judge

Date Issued: 5/24/2022

¹⁰ A taxpayer may also reduce or eliminate the understatement if he or she successfully demonstrates substantial authority for the treatment of any item giving rise to the understatement, or the relevant facts affecting the item's tax treatment were adequately disclosed and there is a reasonable basis for the tax treatment of such item. (IRC, § 6662(d)(2)(B).)

¹¹ FTB revises the amounts of the proposed additional tax to \$45,941, \$47,869, \$98,770, and \$154,575 for tax years 2007, 2008, 2009, and 2010, respectively. FTB revises the amounts of the late filing penalties to \$11,485.25, \$11,967.25, \$24,692.50, and \$38,643.75 for tax years 2007, 2008, 2009, and 2010, respectively. FTB revises the amounts of the accuracy-related penalties to \$9,188.20, \$9,573.80, \$19,754, and \$30,915 for tax years 2007, 2008, 2009, and 2010, respectively.