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OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	OTA Case No. 20106765
R. SHEWARD	

OPINION

Representing the Parties:

For Appellant: R. Sheward

For Respondent: Brian Werking, Tax Counsel III

For Office of Tax Appeals: Steven Kim, Tax Counsel III

T. STANLEY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, R. Sheward (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing additional tax of $1,798, a late-filing penalty of $449.50, a demand penalty of $449.50, a filing enforcement fee of $93, and applicable interest, for the 2017 taxable year.[1]

Appellant waived the right to an oral hearing; therefore, the Office of Tax Appeals (OTA) decided the matter based on the written record.

ISSUE[2]

Does appellant have taxable income from a California source for the 2017 taxable year?

[1] Although appellant appeals the entire amount of the proposed assessment, appellant did not provide any specific arguments for abatement of the late-filing penalty, demand penalty, filing enforcement fee, or interest. Appellant is only contesting the penalties, fee, and interest to the extent the tax was not properly imposed.

[2] To the extent that FTB asserts OTA should confine our inquiry only to whether appellant has a California filing requirement, OTA notes that this appeal arose from issuance of a Notice of Action (NOA), and appellant has appealed the entire amount of the NOA, so OTA may address each component of that NOA.

FACTUAL FINDINGS

1. During 2017, appellant was a nonresident of California, residing in Ohio.
2. On July 7, 2017, appellant contracted with the California Horse Racing Board (CHRB) to serve as a horse racing steward in California. The contract term was for July 1, 2017, through June 30, 2018. The contract indicated that appellant would provide services in California.
3. Under her California contract, appellant had a title of State Steward and judged horse races in California at Cal Expo. Appellant provided similar services during 2017 in the state of Minnesota.
4. Three Forms 1099-MISC reported that appellant received $53,834 from the State of California, $1,147 from the Minnesota Harness Racing, Inc., and $39,320 from the State of Minnesota, totaling $94,301, which was reported on appellant's single federal Schedule C as the total gross receipts of her business. Appellant reported net business income, as a "Race Track Judge," of $51,772.
5. Appellant did not file a California personal income tax return for 2017.
6. On October 1, 2019, FTB issued to appellant a Notice of Proposed Assessment (NPA) proposing additional tax of $1,798, which was based on estimated California source income of $53,824; a late-filing penalty of $449.50; a demand penalty of $449.50;[3] a filing enforcement fee of $93; and applicable interest.
7. Appellant timely protested the NPA, which FTB denied.
8. On August 28, 2020, FTB issued a Notice of Action affirming the NPA.
9. Appellant timely filed this appeal.

DISCUSSION

California residents are taxed upon their entire taxable income regardless of source, while nonresidents are only taxed on income derived from California sources. (R&TC, §§ 17041(a), (b), & (i); 17951.) Every individual taxable under the Personal Income Tax Law is required to file a return with FTB, specifically stating the items of the individual's gross income from all

[3] On July 2, 2018, FTB issued an NPA after appellant failed to respond to a request for a tax return for taxable year 2016. On October 1, 2019, FTB issued an NPA after appellant failed to respond to a demand for a tax return for taxable year 2017. Because OTA is not addressing penalties in this appeal, it need not determine whether the demand penalty was properly imposed for the 2017 taxable year. (See *Appeal of Jones*, 2021-OTA-144P.)

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sources and the deductions and credits allowable, if the individual's gross income exceeds certain threshold amounts. (R&TC, § 18501(a).) If a taxpayer fails to file a return, FTB may, at any time, make an estimate of the net income from any available information and propose an assessment of tax, interest, and penalties due. (R&TC, § 19087(a).) For 2017, for an individual with a single filing status who is under the age of 65 with no dependents, a California filing requirement is triggered if the individual's California gross income was at least $17,029.

When FTB assesses tax based on an estimate of income, FTB has the initial burden to show that its assessment is reasonable and rational. (*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; *Appeal of Bindley*, *supra*.) 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*, (9th Cir. 1997) 116 F.3d 1309, 1312.) Once FTB has met its initial burden, the assessment is presumed correct, and the taxpayer has the burden of proving error in the assessment. (*Todd v. McColgan*, (1949) 89 Cal.App.2d 509, 514; *Appeal of Bindley*, *supra*.)

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

California imposes a tax on the taxable income of a nonresident, such as appellant, to the extent the income is derived from sources within this state. (R&TC, §§ 17041(b) & (i), 17951(a).) Taxable 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 section 17951-4 provides income sourcing provisions applicable to a nonresident's business, trade, or profession. Under Regulation section 17951-4(c), when a sole proprietorship conducts a unitary business within and without California (partly in California and partly outside of 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 through 25139. Thus, the requirements for application of Regulation section 17951-4(c) are as follows: (1) the taxpayer must be a nonresident; (2) the

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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*.) Here, there is no dispute that appellant was a California nonresident during the 2017 taxable year. Likewise, the evidence establishes that appellant conducted her business as a sole proprietor. This is corroborated by appellant's federal Schedule C on which she reported that she was carrying on a horse race judging business. Thus, the first and second requirements of Regulation section17951-4(c) have been met.

The third requirement of Regulation section 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.) Here, the evidence shows that appellant, as the sole proprietor of her business, provided horse race judging in California and Minnesota during the 2017 taxable year.[4] The contract for California services is between the CHRB and appellant and calls for appellant to perform various responsibilities as a Horse Racing Steward. The listed responsibilities suggest that appellant's services are to be performed in California, i.e., attending and supervising in-person horse racing meetings during the day or sometimes at night. Moreover, appellant stated in this appeal that the services were performed in California. Appellant asserts that the services she performs in Minnesota are similar to those duties performed in California. Appellant reported income and expenses for services performed in both states on her federal Schedule C. Appellant, thus, conducted a one-service business controlled and managed by her. OTA's record indicates that appellant operated "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 the State of California and from the State of Minnesota and the Minnesota Harness Racing Commission for

[4] Appellant resided in Ohio and may have conducted part of her business activities (relating to her horse race judging business) from her residence in Ohio.

services rendered as a sole proprietor. Consequently, because appellant performed services both in Minnesota and California (and potentially from her home in Ohio), OTA concludes that appellant was carrying on her trade or business within and without California.

OTA concludes that appellant was operating a unitary business within and without California during the 2017 taxable year. Therefore, OTA turns to the rules for determining the amount of appellant's income to be sourced to California.

California's Market-Based Sales Factor Sourcing Provisions

Regulation section 17951-4(c)(2) provides that the amount of such business income derived from sources within California shall be determined in accordance with the provisions of the apportionment rules of the UDITPA, R&TC sections 25120 to 25139, inclusive, 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 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 taxable year and the denominator is the taxpayer's total sales everywhere during the taxable year. (R&TC, § 25134.) The term "sales" is defined as "all gross receipts derived by the taxpayer from transactions and activity in the regular course of such trade or business." (Cal. Code Regs., tit. 18, § 25134(a)(1).)

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 the service revenue at issue in this appeal. Under R&TC section 25136(a)(1) sales from services are sourced to California to the extent the purchaser of the services receives the benefit of the services in California. Regulation section 25136-2 provides detailed market-based sourcing provisions that implement and interpret R&TC section 25136.

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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., CHRB] or the taxpayer's books and records kept in the normal course of business, notwithstanding the billing 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.

Appellant asserts that she did not have a California tax liability because she is an Ohio resident and claimed all income, including the income received from the CHRB, on her Ohio state return. It is undisputed that appellant is a nonresident of California, and appellant's other sources of income in other states have no bearing on whether appellant earned income from California sources in 2017. As discussed above, appellant's contract with the State of California lists the duties of a Horse Racing Steward, many of which strongly suggest that CHRB received the benefit of appellant's services in California. For example, the contract states that the CHRB

governs horse racing “in this state.” Furthermore, appellant’s duties include, among other things: 1) holding administrative hearings to conduct fact-finding, and issue rulings, statements of decision, and proposed decisions; 2) determining the order of finish of races; 3) taking necessary action to effectively supervise all phases of racing operations at a racing meeting in a manner consistent with applicable horse racing laws; 4) monitoring and observing *daily* habits and practices of backside activities; 5) conducting pre-meet racetrack safety inspections; 6) acting as a liaison between the stewards and CHRB enforcement staff; and 7) enforcing compliance with safety standards. The contract requiring in-person services coupled with appellant’s statement that her role as a state steward required her to “judge horse races at Cal Expo [a facility in California]” allows OTA to determine that the location of the benefit of the services appellant provided to the CHRB was in California. Thus, it is not necessary to proceed to the reasonable approximation rule contained in Regulation section 25136-2(c)(2)(B).

Our analysis does not end here, however, because appellant’s Schedule C, provided to FTB during the protest, shows appellant had gross receipts totaling $94,301 (not just the $53,834 received from the CHRB) from her business performing horse race judging services, and there is no evidence in the record showing that appellant conducted more than one unitary business. Thus, it appears appellant’s income from CHRB was only a portion of her total unitary business judging income. Therefore, under Regulation section 17951-4(c)(1) and (2), OTA must apportion appellant’s total unitary business income to determine her taxable California source income and not simply source the gross receipts from CHRB to California, as FTB has done.[5]

To compute appellant’s sales factor, her California receipts from CHRB of $53,834 is the numerator, and her total worldwide, self-employment income of $94,301 is the denominator (i.e., $53,834/$94,301). This results in a sales factor apportionment percentage of roughly 57.1 percent. Multiplying appellant’s total net unitary business income of $51,772 (as reported by appellant on her federal Schedule C) by a sales factor of 57.1 percent results in California source income of $29,562 (i.e., $51,772 x 0.571), not $53,834 as computed by FTB.

FTB makes several contentions in its reply to an additional briefing request from OTA. First FTB asserts it cannot rely on appellant’s federal tax information because: 1) federal law

[5] The remaining income of $40,467 was paid to appellant by Minnesota Harness Racing, Inc. and the State of Minnesota and appears to be related to appellant’s horse judging services performed in the state ofMinnesota. Nothing in the record suggests that Minnesota Harness Racing, Inc., or the State of Minnesota received the benefit of appellant’s services in California.

does not address California sourcing rules, 2) California relies on returns signed under penalty of perjury, and 3) the income and expense deductions on appellant's federal Schedule C are not clearly distinguishable between business and nonbusiness income as required by Regulation section 17951-4(c)(1).

We disagree that there is anything unreliable in appellant's federal tax return, including the single Schedule C appellant filed to report her horse race judging business. First, the federal return is signed under penalty of perjury. Moreover, the single Schedule C shows gross receipts equating to the three Forms 1099-MISC, further supporting the validity of the federal information. Second, while FTB is correct that the federal law does not address California sourcing rules, OTA concludes that appellant's federal schedule C provides sufficient information to properly compute appellant's California source income. It is the role of OTA to compute the correct amount of tax, and it cannot ignore the information on appellant's federal return simply because appellant held an incorrect belief that she was not required to file a California tax return. 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*.)

"Business income" is income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations." (R&TC section 25120(a).) "Nonbusiness income" means all income other than business income." (R&TC section 25120(d).)

Appellant reports her trade or business as horse race judging, and the income from all three Forms 1099-MISC were reported on a single federal Schedule C "Profit or Loss From Business," which again reports appellant's principal business or profession as "Race Track Judge." All of this is a strong indication that the income from the three Forms 1099-MISC reported on Schedule C related to appellant's trade or business of horse race judging and is business (as opposed to nonbusiness) income.

Because OTA concludes that appellant's income reported on her single federal Schedule C is business income related to appellant's single unitary business of horse race judging, it follows that all of appellant's expenses reported on this Schedule C are related to this

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unitary business income and should be deducted from such unitary business income. Thus, there is no need to assign or allocate such expenses between appellant's business and other (nonbusiness) income under R&TC section 17951-4(c)(1) as FTB contends. Rather, pursuant to R&TC section 17951-4(c)(1) appellant is permitted to deduct "those deductions allowed by law . . . which are attributable to that unitary business" to compute the net income from this business.[6]

FTB further contends that appellant's income received from the State of Minnesota and Minnesota Harness Racing, Inc. should be sourced to California if the benefit of the services for those entities were located in California. There is nothing in the record to suggest that the two Minnesota entities contracted with appellant for services to be performed in California or received the benefit of appellant's service in California. Moreover, appellant indicated that she performed horse race judging services in Minnesota in addition to California during the 2017 taxable year. Just as CHRB received the benefit of appellant's services judging California horse races in California, the State of Minnesota and the Minnesota Harness Racing, Inc. received the benefit of appellant's services judging Minnesota horse races in Minnesota. Therefore, it is more likely than not that the income received by appellant from the Minnesota entities was not California source income.

FTB also asserts that appellant has failed to meet her burden of proof to show that the proposed assessment was incorrect. OTA agrees that when FTB issued the proposed assessment it had made a reasonable estimate of appellant's California source income based on a third-party report; the Form 1099 from CHRB. Although FTB is correct that the burden of proof shifted to appellant once FTB met its initial burden, this is not outcome determinative.[7] The presumption is a rebuttable one. Appellant provided additional information to FTB that was sufficient to rebut the presumption.

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[6] OTA notes that the IRS has not challenged the propriety of appellant's deductions, nor did it disallow the expense deductions appellant claimed on her federal Schedule C.

[7] While initially reasonable and rational, FTB's treatment of the entire amount reported on Form 1099 from CHRB as California source income results in California source income ($53,824) which actually exceeds the total income appellant reported from all sources on her federal return ($53,299).

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Although the initial estimate in the proposed assessment is presumed correct, it is a rebuttable presumption. After the issuance of the proposed assessment, appellant submitted her federal tax return including the Schedule C associated with her horse race judging business. The federal return shows that FTB should have applied its own rules, as discussed above, to calculate a sales factor to apply to appellant's net business income from her single unitary Schedule C horse race judging business as was done above in this Opinion. The federal information is reliable, as conceded by FTB, and contains sufficient information with which to determine the source of appellant's income and to calculate a sales factor to apply to her net business income.

California 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 for a nonresident sole proprietor conducting a unitary business within and without of this state—by applying the provisions of the UDITPA. (Cal. Code Regs., tit. 18, § 17951-4(c)(2).) FTB was unable to show that it properly applied those provisions here.

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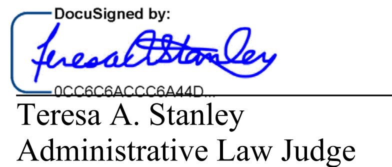
HOLDING[8]

Appellant has taxable income from a California source for the 2017 taxable year.

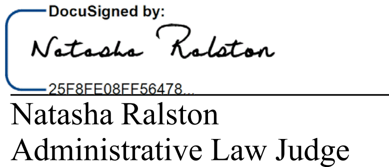
DISPOSITION

FTB's assessment is modified such that $29,562 of appellant's income is California source income. Additionally, appellant's penalties and interest are correspondingly recomputed and reduced based on the revised California source income. Otherwise, FTB's assessment is sustained.

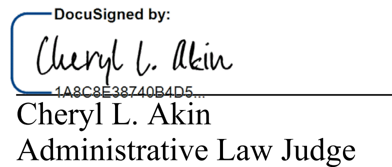


Teresa A. Stanley
Administrative Law Judge

We concur:



Natasha Ralston
Administrative Law Judge



Cheryl L. Akin
Administrative Law Judge

Date Issued: 5/25/2022

[8] To the extent that appellant argues that she pays tax to the State of Ohio, which should be credited, OTA has reviewed appellant's 2017 Ohio state tax return and finds she is not entitled to a credit for other state taxes paid. Appellant did include the California source income on the Ohio return; however, she did not pay taxes on it. Appellant did pay tax on her California income to the City, Village, or Township of Macedonia, Ohio, but OTA does not have authority to offset California state tax for taxes paid to a municipality.