OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **R. HERNANDEZ AND** **W. HERNANDEZ**	OTA Case Number 21037327

OPINION

Representing the Parties:

For Appellant: Pietro Canestrelli, Attorney

For Respondent: Christopher T. Tuttle, Tax Counsel III

For Office of Tax Appeals: Tom Hudson, Tax Counsel III

V. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, R. Hernandez (appellant-wife) and W. Hernandez (appellant-husband) (collectively, appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing additional tax of $9,818.00, an accuracy-related penalty of $1,963.60, and applicable interest for the 2016 tax year.

Appellants waived their right to an oral hearing; therefore, the matter is being decided based on the written record.

ISSUES

1. Whether appellants have shown error in the proposed assessment of additional tax, which was based on a final federal determination.
2. Whether appellants have shown reasonable cause for the abatement of the accuracy-related penalty.

FACTUAL FINDINGS

1. Appellants filed a timely joint California income tax return. Appellants' return reports that appellant-wife operated a construction consulting business from appellants' personal residence.

2. FTB subsequently received information indicating that the IRS audited appellants' 2016 return and made adjustments: disallowing appellant-wife's Schedule C (Profit or Loss from Business) deductions comprised of "other expenses" of $32,235 and car and truck expenses of $27,404; disallowing appellants' Schedule A (Itemized Deductions) comprised of medical expenses of $9,323 (rounded) and "net miscellaneous deductions" of $45,619; increasing appellants' income by $37,800 of ordinary dividends received during the year; and increasing appellants' self-employment tax by $8,427. The federal adjustments resulted in federal tax due and the imposition of the federal accuracy-related penalty. Appellants did not report these changes to FTB.
3. FTB made corresponding adjustments to appellants' California taxable income, to the extent applicable under California law, and issued appellants a Notice of Proposed Assessment (NPA). The NPA disallowed the same Schedule C and Schedule A expenses, disallowed Schedule A medical and dental expenses of $6,991.00, included the same additional income, and allowed a deduction of $4,213.00 for one-half of appellants' self-employment tax. The NPA proposed additional tax of $9,818.00 and an accuracy-related penalty of $1,963.60, plus interest.
4. Appellants protested the NPA and asserted that the federal determination was erroneous and indicated that they had requested reconsideration of the federal audit. FTB received information from the IRS confirming that the federal adjustment was a final federal determination and FTB issued a Notice of Action affirming the NPA.
5. This timely appeal followed.
6. On appeal, appellants provide documentation including an annual invoice for office cleaning totaling $2,220.00, monthly receipts for lawn care services totaling $1,440.00, a packing slip for chemical proof pants totaling $729.01, an undated cell phone sales contract totaling $949.00, appellant-wife's mileage log showing the vehicle driven, date, odometer reading, and miles driven, invoices for medical and dental expenses totaling $38,189.62, and two casino statements showing gambling losses.

7. On appeal, FTB indicates that it will accept the invoice totaling $2,220.00 for office cleaning as adequate substantiation and will also allow additional Schedule A expenses of $2,643.61.[1]

DISCUSSION

Issue 1: Whether appellants have demonstrated error in the proposed assessment of additional tax, which was based on a final federal determination.

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; *Appeal of Gorin*, 2020-OTA-018P.) 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; *Appeal of Bindley*, 2019-OTA-179P.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Bracamonte*, 2021-OTA-156P; *Appeal of Gorin*, *supra*.)

Here, FTB based its proposed assessment of additional tax on the IRS's final audit determination for the 2016 tax year. The evidence in the appeal record indicates that the IRS has not revised or cancelled its determination. As the federal determination has not been revised or cancelled, in order to prevail in this appeal appellants must show error in the federal adjustments upon which FTB based its proposed assessment.

Appellants' Schedule C Business Expense Deductions for "Other Expenses"

Income tax deductions are a matter of legislative grace, and a taxpayer who claims a deduction has the burden of proving by competent evidence that he or she is entitled to it. (*Appeal of Vardell*, 2020-OTA-190P.) To support a deduction, the taxpayer must establish by credible evidence, other than mere assertions, that the deduction claimed falls within the scope of a statute authorizing the deduction. (*Appeal of Dandridge*, 2019-OTA-458P.) A taxpayer's burden of proof is not relieved because it may be difficult or impossible to substantiate his or her position. (*Appeal of Johnson*, 2022-OTA-166P.)

[1] FTB states that this amount represents documented expenses, but does not clarify which specific expenses are being allowed and included in this $2,643.61 of additional allowed Schedule A expenses.

Internal Revenue Code (IRC) section 162 permits taxpayers to deduct ordinary and necessary business expenses paid or incurred during the tax year in carrying on a trade or business.[2] To be deductible, the expenses must be directly connected with or pertaining to the taxpayer's trade or business. (Treas. Reg. § 1.162-1(a).) In contrast, personal, living, or family expenses are generally not deductible. (IRC, § 262(a).) Appellants' federal income tax return states that appellant-wife operates a home office for her construction consulting business from appellants' residence and claims a deduction under IRC section 280A for a portion of otherwise personal expenses incurred in connection with her personal residence.

Appellants contend they should be allowed a deduction for Schedule C business expenses of $32,235.00 for "other expenses" incurred in appellant-wife's business. To substantiate the expenses, appellants provided an annual invoice for office cleaning totaling $2,220.00, monthly receipts for lawn care services totaling $1,440.00, a packing slip for $729.01, and an undated sales contract for a cell phone totaling $949.00.

In its opening brief, FTB accepted appellants' office cleaning expenses of $2,220 and conceded this portion of the claimed expenses. However, unlike office cleaning expenses, it is unclear how appellants' lawn care expenses related to appellant-wife's business. Though lawn care expenses may be deductible in part where a taxpayer regularly has clients visiting the home office and lawn care is of significance to the taxpayer's business operations, no such assertions or evidence have been offered in this case.[3] Thus, the lawn care expenses incurred for appellants' personal residence are a personal expense and are not deductible.

The packing slip appears to be for six pairs of chemical-proof pants, corroborating part of the "chemical proof uniform" deduction claimed as an "other deduction" on appellants' Schedule C. This $729.01 portion of Schedule C expenses has been adequately substantiated.

As to the undated cell phone sales contract, it is unclear whether this expense was incurred in connection with appellant-wife's business, and it is also unclear whether the expense

[2] IRC sections 162, 262, 274 and 280A are generally incorporated into California law by R&TC section 17201.

[3] See IRS 2016 Publication 587, p. 7, and Prop. Treas. Reg. § 1.280A-(i)(3). See also *Hefti v. Commissioner*, T.C. Memo. 1988-22, permitting deduction for the proportional percentage of lawn care expenses allocable to business use of residence, where taxpayer had clients visiting on a regular basis such that lawn maintenance was of significance to the taxpayer's business. See also IRS Private Letter Ruling 8534021, disallowing lawn care expense deduction to taxpayer who operated a landscape architecture business because no portion of the yard was used exclusively and regularly as the taxpayer's principal place of business or to meet clients on a regular basis.

was paid or incurred during tax year 2016 because the contract is undated. Based on this, the cell phone expense is disallowed.

Therefore, appellants have substantiated $2,949.01[4] of the $32,235 "other expenses" deducted on Schedule C, but have not provided documentation to establish entitlement to the remaining deductions.

Appellants' Schedule C Business Expense Deductions for Car and Truck Expenses

For certain deductions, such as traveling expenses and deductions related to "listed property," which includes passenger automobiles, taxpayers must provide special documentation and substantiation. (See IRC, § 274(d).) To qualify for such a deduction, a taxpayer must substantiate "by adequate records or by sufficient evidence corroborating the taxpayer's own statement (A) the amount of such expense or other item, (B) the time and place of the travel . . . or use of the facility or property, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of persons . . . using the facility or property ....." (IRC, § 274(d); see also *Roberts v. Commissioner,* T.C. Memo. 2012-197.)

With respect to listed property such as passenger automobiles, the federal regulations provide that taxpayers will have maintained "adequate records" if they keep a contemporaneous account book, diary, log, statement of expense, trip sheets, or similar record combined with supporting documents, which substantiate the required elements of the expenses, such as the amount, the date, and the business purpose of use of the item. (Treas. Reg. § 1.274-5T(c)(2).) If adequate records (such as a contemporaneous account book, diary, log, statement of expense, trip sheets, etc.) are not provided under this provision, taxpayers must establish each element of the expense by their own statement containing specific detail as to each element, *and* provide "other corroborative evidence sufficient to establish such element." (Treas. Reg. § 1.274-5T(c)(3), italics added.)

The substantiation requirements for compliance with IRC section 274 are stricter than those required for other kinds of deductions, particularly the deduction for ordinary and necessary business expenses found in IRC section 162. (*D.A. Foster Trenching Co. v. U. S.* (Ct. Cl. 1973) 473 F.2d 1398.) "General or vague proof, whether offered by testimony or

[4] $2,220.00 of office cleaning supplies + $729.01 chemical proof pants = $2,949.01.

documentary evidence, will not suffice. Specificity is imperative." (*Goldberger v. Commissioner* (1987) 88 T.C. 1532, 1558.)

Appellants reported car and truck expenses of $27,404.00 on their Schedule C for appellant-wife's construction consulting business, which was disallowed in full by the IRS and FTB. Appellants provided a mileage log that identifies dates, vehicles used, odometer readings, and miles driven. Appellants also provided the lease agreement for a vehicle, dated October 1, 2016, requiring 36 monthly payments of $929.92. These documents are insufficient to substantiate a deduction for car and truck expenses because the documents do not reflect a business purpose for the expenses, and it is unclear whether these expenses were incurred by appellant-wife in her construction consulting business, or by appellant-husband as unrelated employee expenses.[5] Regardless, appellants' mileage log does not provide any information about where appellants drove, or the business purpose served. The lease agreement for the vehicle also does not provide any evidence that the vehicle was used for business purposes. Therefore, appellants have not shown they are entitled to any deduction for car and truck expenses.

Appellants' Schedule A Itemized Deduction for "Net Miscellaneous Expenses"

Appellants reported that they incurred $48,156.00 of miscellaneous expenses, less the two percent of their adjusted gross income (AGI), resulting in a net deduction of $45,619.00. This deduction was fully disallowed by the IRS and FTB. On appeal, FTB conceded that appellants are entitled to $2,643.61 in Schedule A net miscellaneous deductions. Appellants assert that they are entitled to deduct the entire $45,619.00, but have not provided evidence to substantiate the expenses. Accordingly, other than the amount conceded by FTB, appellants have not shown that they are entitled to further Schedule A net miscellaneous deductions.

[5] Although appellants' Schedule C reports the profit and loss for appellant-wife's construction consulting business, appellants' opening brief states that appellant-husband incurred the car and truck expenses. Though this may have been a misstatement of fact, it further demonstrates the need for additional substantiation. It remains unclear whether any of the mileage shown in appellants' mileage log was included in appellant-husband's deduction for unreimbursed employee business expenses reported on appellants' Schedule A, which included $29,088 of vehicle expenses.

Appellants' Schedule A Itemized Deduction for Medical and Dental Expenses

IRC section 213(a) defines the medical and dental expense deduction as "the expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent… to the extent that such expenses exceed ten percent of adjusted gross income." (IRC, § 213(a).)[6] R&TC section 17241(a) modifies IRC section 213(a) by substituting seven and a half percent for ten percent.

Appellants reported medical and dental expenses of $38,774 on Schedule A of their 2016 income tax return, less ten percent of their reported AGI, plus a California adjustment of $3,172, for a total deduction of $29,259 for California tax purposes. As a result of the federal audit, appellants' AGI increased by $93,226. Because the federal medical and dental expense deduction is only permitted to the extent the expenses exceed ten percent of a taxpayer's AGI, the IRS reduced appellants' allowable deduction by ten percent of the increase in their AGI, or $9,323 (rounded). Similarly, California law permits the deduction only to the extent expenses exceed seven and a half percent of a taxpayer's AGI. FTB reduced the amount of appellants' deduction by seven and half percent of the revised AGI, or $6,991 (rounded).[7]

Appellants have substantiated medical and dental expenses of $38,189.62 (compared to $38,774.00 as reported by appellants on their federal Schedule A). However, for California purposes the deduction is only allowed to the extent that it exceeds 7.5 percent of appellants' AGI. Taking into consideration the additional $2,949.01 of Schedule C expenses allowed on appeal, 7.5 percent of appellants' revised AGI is $16,286.02, which means that appellants have substantiated entitlement to a net medical and dental expense deduction of $21,903.60. Compared to the amount of $22,268[8] allowed by the FTB after audit, appellants have not established that they are entitled to any additional medical and dental expense deduction because the net deduction allowed ($22,268) exceeds the net deduction appellants have substantiated ($21903.60).

[6] This deduction is incorporated into California law by R&TC section 17201.

[7] 7.5 percent of $93,226.00 is $6,991.95.

[8] $26,087 reported on appellants' federal Schedule A + $3,172 Schedule CA adjustment- $6,991 disallowed per FTB's NPA.

Appellants' Increased Income

The IRS adjusted appellants' income to include $37,800 of income characterized as ordinary dividends. Appellants assert this income was generated by gambling winnings, which were offset by unreported gambling losses, and provides casino statements to show gambling losses. However, the federal adjustment to appellants' 2016 tax year does not indicate that this additional income for gambling winnings and there is no evidence in the record that the IRS audit determined that appellants had gambling winnings. Therefore, Office of Tax Appeals need not discuss the sufficiency of the evidence that appellants provided because appellants have not shown that they had any taxable gambling winnings that can be offset by their purported gambling losses. (See IRC, § 165(d) [allowing gambling losses only to the extend of gambling winnings/gains].)[9]

Neither party to this appeal has offered any information, explanation, or arguments regarding the ordinary dividends. However, as a matter of law, FTB's determination based on a federal adjustment to income is presumed correct and appellants bear the burden of proving FTB's determination is erroneous. (*Appeal of Valenti*, *supra*.; *Appeal of Gorin*, *supra*.) Accordingly, appellants have not demonstrated that this adjustment is erroneous.

Issue 2: Accuracy-Related Penalty.

R&TC section 19164, which generally incorporates the provisions of IRC section 6662, provides for an accuracy-related penalty of 20 percent of the applicable underpayment. The penalty applies to the portion of the underpayment attributable to (1) negligence or disregard of rules and regulations, or (2) any substantial understatement of income tax. (IRC, § 6662(b).)

FTB imposed an accuracy-related penalty on the basis of appellants' substantial understatement of tax for the 2016 tax year. For an individual, there is a "substantial understatement of income tax" when the amount of the understatement for a tax year exceeds the greater of ten percent of the tax required to be shown on the return, or $5,000. (IRC, § 6662(d)(1).) Here, appellants should have reported California tax of approximately $9,800 and they reported zero California tax on their 2016 return. Accordingly, the understatement was substantial.

[9] California conforms to IRC section 165 per R&TC section 17201.

The penalties may be reduced or abated if appellants can show (1) there is substantial authority for appellants' reporting position, (2) the position was adequately disclosed in the tax return (or a statement attached to the return)[10] and there is a reasonable basis for treatment of the item, or (3) that they acted in good faith and had reasonable cause for the understatement. (IRC, §§ 6662(d)(2)(B), 6664(c)(1); R&TC, § 19164(d); Cal. Code Regs., tit. 18, § 19164(a).)

A determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case by-case basis and depends on the pertinent facts and circumstances, including the taxpayer's efforts to assess the proper tax liability, the taxpayer's knowledge and experience, and the extent to which the taxpayer relied on the advice of a tax professional. (Treas. Reg. § 1.6664-4(b)(1).) Reasonable cause may be established where the taxpayer reasonably relies on the substantive tax advice of a tax professional as to whether a tax liability exists, and the following conditions are met: (1) the person relied on by the taxpayer is a tax professional with competency in the subject tax law; and (2) the tax professional's advice is based on the taxpayer's full disclosure of the relevant facts and documents. (*Appeal of Summit Hosting LLC*, 2021-OTA-216P.[11])

Appellants assert that they reasonably relied in good faith on the advice of the tax preparer who submitted their returns. However, appellants have not identified what erroneous advice they received or provided acknowledgment from the tax professional that the preparer received all relevant facts and documents from appellants. The evidence in the record is insufficient to support a conclusion that appellants had reasonable cause and acted in good faith. Therefore, the accuracy-related penalty cannot be abated.

[10] To qualify as an adequate disclosure, Treasury Regulations generally require that the taxpayer disclose the details of his or her position on either a Federal Form 8275, a Form 8275-R, or a qualified amended return. (Treas. Reg. § 1.6662-4(f).) The record does not show that appellants made any such disclosure.

[11] Although *Appeal of Summit Hosting, LLC, supra,* relates to reasonable cause (based on the asserted reliance on substantive tax advice of a tax professional) for abatement of late-filing penalty, OTA finds this analysis equally applicable in the context of the accuracy related penalty where appellants are asserting reasonable cause based on reliance on substantive tax advice of a tax profession.

HOLDINGS

1. The proposed assessment is modified to allow a deduction of $2,949.01 on Schedule C for "other expenses," and to allow a deduction of $2,643.61 on Schedule A for "net miscellaneous deductions." Appellants have not shown error in the remaining amount of the proposed assessment of additional tax for 2016.
2. Appellants have not shown reasonable cause for abatement of the accuracy-related penalty.

DISPOSITION

FTB's proposed assessment is reduced to allow additional Schedule C expense deductions of $2,949.01 and Schedule A expense deductions of $2,643.61. Otherwise, FTB's action is sustained.

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Veronica I. Long
Administrative Law Judge

We concur:

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Richard Tay
Administrative Law Judge

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Eddy Y.H. Lam
Administrative Law Judge

Date Issued: 3/15/2023