OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **L. CONCEPCION AND** **J. CONCEPCION**	OTA Case No. 19105360

OPINION

Representing the Parties:

For Appellants: Cruz Saavedra, Attorney

For Respondent: Brad J. Coutinho, Tax Counsel III

For Office of Tax Appeals: Linda Frenklak, Tax Counsel V

A. VASSIGH, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, L. Concepcion and J. Concepcion (appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing additional tax of $63,129.00 and imposing an accuracy-related penalty of $9,469.35, plus interest, for the 2010 tax year. On appeal, FTB agrees to grant appellant-wife conforming innocent spouse relief under R&TC section 18533(i) for the 2010 tax liability at the conclusion of this appeal.

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

ISSUES[1]

1. Whether FTB's proposed assessment is barred by the statute of limitations.
2. Whether appellants have established error in FTB's proposed assessment of additional tax, which is based on federal adjustments.
3. Whether appellants have established that the accuracy-related penalty should be abated.

FACTUAL FINDINGS

1. On October 17, 2011, appellants filed a joint California Resident Income Tax Return, Form 540, for the 2010 tax year. Appellants reported a total tax of $290. After claiming income tax withholdings of $15,559, they claimed an overpayment of $15,269. On their Form 1040, which appellants attached to their California return, appellants reported a business loss of $70,122 and a rental real estate, etc. loss of $97,303.
2. FTB accepted appellants' 2010 return as filed. On December 14, 2011, FTB refunded the claimed overpayment of $15,269, plus interest.
3. As reflected on the FEDSTAR IRS Data Sheet for appellants' 2010 tax year, the IRS audited and adjusted appellants' 2010 Form 1040, increasing their reported taxable income by $654,869.00. As reflected on appellant-husband's 2010 separate assessment federal account transcript, the IRS assessed additional tax of $235,696.00 and imposed an accuracy-related penalty of $35,354.40, plus interest, which became final on August 9, 2017, after the conclusion of the U.S. Tax Court proceeding discussed below.[2] The IRS' Notice of Tax Due on Federal Return, dated August 9, 2017, indicates that the federal accuracy penalty was imposed for substantial understatement of tax.

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[1] In appellants' opening brief, appellant-wife claimed she should not be held jointly liable for the proposed assessment and penalty in this appeal. Since appellant-wife had been granted federal innocent spouse relief for the couple's 2010 federal tax liability, and FTB determined that she was entitled to conforming relief under R&TC section 18533(i), OTA provided appellant-husband an opportunity to provide any information indicating that FTB should not grant appellant-wife conforming relief. In his reply brief, appellant-husband conceded that appellant-wife was entitled to innocent spouse relief., stating that "these recitals remove [appellant-wife] as she has been relieved under the Innocent Spouse Provisions of the Revenue and Taxation Code." Since there is no longer any dispute as to this matter and all parties are in agreement, OTA will not review FTB's determination that appellant-wife is entitled to conforming innocent spouse relief.

Though appellant-wife has been granted innocent spouse relief in full, and this is not a disputed issue in this appeal, appellant-wife has not withdrawn from this appeal. As a result, her name has not been removed from this Opinion, and the Opinion refers to "appellants," which for all practical purposes, should be taken to mean "appellant-husband."

[2] The federal accuracy-related penalty of $35,354.40 is 15 percent of the federal assessed additional tax of $235,696.00.

4. Appellants filed a petition with the U.S. Tax Court concerning the adjustments the IRS made to their 2010 federal return. On May 18, 2017, counsel for appellant-husband signed a stipulation in the U.S. Tax Court proceedings. The U.S. Tax Court signed an order dated June 13, 2017, which stated that, pursuant to the agreement of appellants and the IRS, it was ordered and decided that, after application of Internal Revenue Code (IRC) section 6015(b), appellant-husband was solely liable for the 2010 tax liability of $235,696.00 and accuracy-related penalty of $35,354.40 and there was no 2010 joint tax liability or joint accuracy-related penalty.
5. On February 12, 2018, FTB received from the IRS a copy of the FEDSTAR IRS Data Sheet for appellants' 2010 tax year. To the extent applicable under California law, FTB made corresponding adjustments to appellants' 2010 return.
6. FTB issued appellants a Notice of Proposed Assessment (NPA) dated October 17, 2018. The NPA increased appellants' reported 2010 taxable income by $679,654.00, consisting of Schedule C returns and allowances of $66,000.00, Schedule C cost of goods sold of $556,059.00, Schedule E income/loss of $47,762.00, and an itemized deduction limitation of $24,785.00, less a one-half self-employment tax deduction of $14,952.00. Excluding the itemized deduction limitation of $24,785.00, these adjustments amount to $654,869.00, which is the amount of the federal adjustments reflected in appellants' 2010 FEDSTAR IRS Data Sheet. FTB denied appellants' claimed exemption credits. FTB proposed additional tax of $63,129.00 and imposed an accuracy-related penalty of $9,469.35, plus interest.[3]
7. Appellants each protested the NPA, and in a letter to both appellants dated July 5, 2019, FTB acknowledged receipt of their protest letters. FTB asserted that the proposed assessment is based on the federal determination, which was not cancelled or reduced. FTB requested that appellants produce within 30 days a revised federal report, indicating that the IRS revised or cancelled the 2010 federal determination, or a letter from the IRS, stating that it was reconsidering and re-opening appellants' case.
8. After appellants failed to respond to its July 5, 2019 letter, FTB issued a Notice of Action dated September 20, 2019, affirming the NPA.

[3] The California accuracy-related penalty of $9,469.35 is 15 percent of the proposed additional tax of $63,129.00.

9. Appellants jointly filed this timely appeal.

10. In a memorandum to OTA dated December 11, 2019, FTB indicated that it requested that appellants provide additional information and evidence to support their position that the 2010 proposed assessment is erroneous.

11. In his reply brief, appellant-husband states, "With respect to [appellant-husband], it is acknowledged that a liability does exist which will be determined by the final ruling in this case." Attached to appellant-husband's reply brief is appellant-husband's declaration, which he signed under penalty of perjury. He attached to his declaration a schedule of flights and crew members. Appellant-husband's estimate of travel expenses included categories for "aircraft," "flight crew," "fuel cost," and "hotel per diem" but does not explain how the amounts were estimated or determined.

DISCUSSION

Issue 1: Whether FTB's proposed assessment is barred by the statute of limitations.

In general, FTB must issue a proposed assessment within four years after the date that the return was filed. (R&TC, § 19057(a).) If there are adjustments to a taxpayer's federal account and the taxpayer or the IRS notifies FTB within six months of the date that the federal changes become final, then FTB may issue a proposed assessment within two years of the date of notification, or within the general four-year statute of limitations period, whichever expires later. (R&TC, § 19059(a).) R&TC section 19060(b) provides that, if the taxpayer or the IRS notifies FTB of the federal change or correction after the six-month period required by R&TC section 18622, then FTB may issue a proposed assessment within four years of the date of the notification.[4] R&TC section 19060(a) provides that if the taxpayer fails to notify FTB of the federal changes, then FTB may issue a proposed assessment at any time.

In the appeal letter, appellant-wife simply states that it is her "understanding that the time for the FTB to assess taxes against [her] under the FTB statute of limitations has expired as provided by the Revenue and Taxation Code." Appellants filed their 2010 California return on October 17, 2011. The IRS adjusted appellants' 2010 federal account, which became final on

[4] R&TC section 18622(d) provides for federal determinations that become final on or after January 1, 2000, the date of the final federal determination shall be the date on which each adjustment or resolution resulting from an IRS examination is assessed pursuant to IRC section 6203. IRC section 6203 states in part, "The assessment shall be made by recording the liability of the taxpayer in the office of the Secretary in accordance with rules or regulations prescribed by the Secretary."

August 9, 2017, as reflected on appellant-husband's 2010 separate assessment federal account transcript and Notice of Tax Due on Federal Tax Return. The IRS notified FTB of the federal changes on February 12, 2018, which was a few days more than six months after the federal changes became final.

FTB issued the NPA on October 17, 2018, which is within four years of the notification date, February 12, 2018. (R&TC, § 19060(b).) Accordingly, the NPA was timely issued.

Issue 2: Whether appellants have demonstrated error in the proposed assessment of additional tax, which is based on federal adjustments.

R&TC section 18622(a) provides that the taxpayer shall either concede the accuracy of a federal determination or state where it is erroneous. It is well settled that FTB's proposed assessment based on a federal determination is presumptively correct and the taxpayer bears the burden of proving that the determination is erroneous. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Valenti*, 2021-OTA-093P.) Unsupported assertions are insufficient to satisfy a taxpayer's burden of proof. (*Appeal of Mazer*, 2020-OTA-263P.) In the absence of credible, competent, and relevant evidence showing that FTB's proposed assessment is incorrect, it must be sustained. (*Appeal of Bracamonte*, 2021-OTA-156P.)

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 that deduction or credit. (*New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435, 440; *Appeal of Vardell*, 2020-OTA-190P.) To meet that burden, a taxpayer must point to an applicable statute and show by credible evidence that the transactions in question come within its terms. (*Appeal of Jindal*, 2019-OTA-372P.) FTB's denial of a claimed deduction is presumed correct until the taxpayer has proven his or her entitlement. (*Appeal of Janke* (80-SBE-059) 1980 WL 4988.)

R&TC section 17201 incorporates IRC section 162(a), which permits a taxpayer to deduct all the ordinary and necessary expenses the taxpayer paid or incurred during the tax year in carrying on any trade or business. A general statement by a taxpayer, indicating that "expenses were paid in pursuit of a trade or business is insufficient to establish that the expenses had a reasonably direct relationship to any such trade or business." (*Chancellor v. Commissioner*, T.C. Memo. 2021-50, quoting *Sham v. Commissioner*, T.C. Memo. 2020-119.).

Appellant-husband argues in his reply brief that OTA should apply the *Cohan* rule (*Cohan v. Commissioner* (2d Cir. 1930) 39 F.2d 540, 543-544) to estimate the expenses he

incurred in operating his business. The *Cohan* rule states that when the evidence establishes that the taxpayer incurred deductible expenses but the exact amount cannot be determined because the taxpayer is unable to provide evidence supporting the entitlement, it is appropriate to use an estimate "bearing heavily . . . upon the taxpayer whose inexactitude is of his own making." (*Ibid*.) The taxpayer has a responsibility to maintain adequate records to verify the amounts and purpose of claimed deductions. (See, e.g., *Wienke v. Commissioner*, T.C. Memo. 2020-143.) A court or other finder of fact, "cannot estimate a deductible expense, however, unless the taxpayer presents evidence sufficient to provide some basis upon which an estimate may be made." (*Fleming v. Commissioner*, T.C. Memo. 2010-60, citing *Vanicek v. Commissioner* (1985) 85 T.C. 731, 743.) "Otherwise an allowance would amount to 'unguided largesse.'" (*Weiderman v. Commissioner*, T.C. Memo. 2020-109, quoting *Norgaard v. Commissioner* (9th Cir. 1991) 939 F.2d 874, 879.)

Here, FTB proposed an assessment of additional tax based on adjustments made to appellants' federal income, which are reflected in the Tax Court's order that is based on a settlement agreement executed by the IRS and appellants. The record does not show that the federal adjustments have been modified, altered, withdrawn, cancelled, or rescinded. Appellants argue on appeal that this settlement agreement overstates appellant-husband's earnings and fails to provide him enough credit for fuel cost expenses for his air charter business (for which he was the chief pilot). FTB agreed to consider any evidence appellants would be able to provide to support their position in this appeal.

In response, appellant-husband provided with his reply brief a declaration he signed under penalty of perjury and a schedule of flights and crew members. The declaration lists the expenses for "Crew Overnights and Travel" and "Jet Fuel" as $13,528 and $400,662, respectively, whereas the schedule lists the expenses for "Flight Crew" and "Fuel Est. Cost" as $80,000 and $267,435. In his declaration, appellant-husband states, "that the $400,662 in jet fuel was expended and it would not have been possible to complete the documents [sic] flights without obtaining and paying for fuel."

Appellant-husband contends that he paid cash for fuel, but has not explained why he could not have obtained and retained receipts for these cash purchases. Appellants have not explained how appellant-husband calculated the 2010 accumulated total of all costs associated with the air charter service business that he jointly owned, as well as the other adjusted items.

Nor have appellants produced any contemporaneous documents that substantiate the information in the submitted declaration and schedule. Moreover, appellants did not provide any additional information or documents to establish that the proposed assessment is erroneous. Appellants have not provided a reasonable explanation for failing to satisfy their obligation to maintain adequate records to verify the items and amounts reported on their 2010 federal and California returns. Instead, appellants provide only unsupported assertions regarding the claimed deductions which is insufficient to meet appellants' burden of proof. (*Appeal of Mazer*, *supra*.) Furthermore, OTA declines to apply the *Cohan* rule to estimate any claimed expenses because, based on the evidence in the record, OTA has no basis for making such an estimate. Appellants have failed to carry their burden of proving that the proposed assessment, which is based on federal adjustments, is incorrect.

Issue 3: Whether appellants are liable for the accuracy-related penalty.

R&TC section 19164 generally incorporates the provisions of IRC sections 6662 and 6664 and imposes an accuracy-related penalty of 20 percent on any portion of the underpayment attributable to a substantial understatement of income tax. (IRC, § 6662(b)(2).) An understatement of tax 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 tax imposed that is shown on the return, reduced by any rebate. (IRC, § 6662(d)(2)(A).) For individual taxpayers, the understatement of income tax is substantial if it exceeds the greater of 10 percent of the tax required to be shown on the return, or $5,000. (IRC, § 6662(d)(1)(A).)

The taxpayer bears the burden of proving any defenses to the imposition of the accuracy-related penalty. (*Recovery Group, Inc. v. Commissioner*, T.C. Memo. 2010-76, *affd*. (1st Cir. 2011) 652 F.3d 122.) In determining whether there is a substantial understatement, the amount of the understatement shall be reduced by any portion of the understatement that is attributable to: (1) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment; or (2) any item if the relevant facts affecting the item's tax treatment were adequately disclosed in the return (or in a statement attached to the return) and there is a reasonable basis for the tax treatment of the item by the taxpayer. (IRC, § 6662(d)(2)(B); see also Treas. Reg. § 1.6662-4(d)-(f).)

IRC section 6664(c)(1) provides that the accuracy-related penalty shall not be imposed under IRC section 6662 "with respect to any portion of an underpayment if it is shown that there

was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion." A taxpayer's reliance on a professional's advice may constitute reasonable cause and good faith if the taxpayer's reliance on the advice was reasonable and if the taxpayer acted in good faith in relying on the advice. (Treas. Reg. § 1.6664-4(c).) Courts have set forth the following three factors that may be used to determine whether reliance on a professional's advice is reasonable: (1) the professional was independent and had sufficient expertise to justify reliance; (2) the taxpayer provided necessary and accurate information to the professional; and (3) the taxpayer relied in good faith on the professional's advice. (*Hewitt v. Commissioner*, T.C. Memo. 2020-89, citing *Neonatology Associates, P.A. v. Commissioner* (2000) 115 T.C. 43, 98-99, *affd*. (3d Cir. 2002) 299 F3d. 221.)

Here, the U.S. Tax Court imposed an accuracy-related penalty of $35,354.40, which is only 15 percent of the assessed additional tax of $235,696.00.[5] FTB imposed a 15 percent accuracy-related penalty in conformity with the federal accuracy-related penalty. Appellants' understatement of California income tax of $63,129.00 is substantial because it exceeds $6,342.00, which is 10 percent of the tax required to be shown on the return, $63,419.00, and is greater than $5,000.00. FTB thus properly imposed an accuracy-related penalty because there was a substantial understatement of tax.

Appellants do not contend, and the evidence does not show that any portion of the understatement is attributable to: (1) appellants' tax treatment of an item for which there is or was substantial authority for such treatment or (2) any item for which the relevant facts affecting the item's tax treatment were adequately disclosed in appellants' return (or in a statement attached to the return) and there is a reasonable basis for appellants' tax treatment of the item. (IRC, § 6662(d)(2)(B).) Although appellants contend that the accuracy-related penalty should be abated because they reasonably relied on their accountant, they have not provided any evidence to establish that they reasonably relied on a professional's advice. (IRC, § 6664(c).) Appellants have not met their burden of proving any defense to the imposition of the accuracy-related penalty. Accordingly, appellants are liable for the accuracy-related penalty.

[5] It is unclear why the Tax Court did not impose an accuracy-related penalty of 20 percent of the applicable underpayment pursuant to IRC section 6662. A reduced accuracy-related penalty amount may have been the result of the IRS and appellants having reached a settlement agreement, as indicated by the Tax Court decision.

HOLDINGS

1. FTB's proposed assessment is not barred by the statute of limitations.
2. Appellants have not established error in the proposed assessment of additional tax, which is based on federal adjustments.
3. Appellants have not established that the accuracy-related penalty should be abated.

DISPOSITION

FTB's action is sustained, and appellant-wife will be fully relieved of the 2010 tax liability pursuant to R&TC section 18533(i) when this appeal is concluded.

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Amanda Vassigh
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Amanda Vassigh
Administrative Law Judge

We concur:

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Richard Tay
Administrative Law Judge

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Andrea LH Long
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Andrea L.H. Long
Administrative Law Judge

Date Issued: 5/19/2023