

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:) OTA Case No. 20056210
J. PENHALL AND)
P. PENHALL)
_____)

OPINION

Representing the Parties:

For Appellants: J. Penhall and P. Penhall

For Respondent: Anne Mazur, Specialist

O. AKOPCHIKYAN, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19324, J. Penhall and P. Penhall (appellants) appeal actions by respondent Franchise Tax Board (FTB) denying appellants’ claim for refund of \$45,055.44 for the 2006 tax year and \$14,108.74 for the 2007 tax year.

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

ISSUE

Whether appellants have established that they are entitled to a refund for the 2006 and 2007 tax years.

FACTUAL FINDINGS

1. Appellants timely filed their 2006 and 2007 California income tax returns and reported no tax due for each year.
2. The IRS subsequently audited appellants’ 2006 and 2007 federal income tax returns. For the 2006 tax year, the IRS determined that appellants underreported their proceeds from the sale of securities by \$268,437. On their original return, appellants reported they sold \$781,896 in securities with a tax basis of \$798,933. The IRS determined that appellants received a total of \$1,050,333, not \$781,896, from the sale of securities. The IRS

- allowed appellants' entire tax basis in the reported securities but did not allow any tax basis for the unreported securities due to lack of substantiation.
3. The IRS also disallowed \$129,679 of cost of goods sold (COGS) for appellant-husband's sole proprietorship, South County Distributing, due to lack of substantiation. Appellant-husband owned and operated vending machines through South County Distributing during the 2006 and 2007 tax years. The IRS allowed the full amount of COGS for the 2006 tax year, \$152,946, after reviewing the records. However, the IRS did not allow any COGS for the 2007 tax year due to lack of substantiation.
 4. The IRS also increased South County Distributing's gross sales from \$209,681 to \$318,400 for the 2006 tax year, and from \$194,481 to \$205,964 for the 2007 tax year.
 5. In March 2010, appellants filed amended 2006 and 2007 California tax returns to report the federal adjustments. The amended returns reported total tax of \$29,166 for the 2006 tax year and \$9,609 for the 2007 tax year based on the federal adjustments. Appellants did not make a payment for either tax year.
 6. In December 2010, FTB filed a state tax lien for the 2006 and 2007 tax years. Appellants subsequently filed for bankruptcy and, although the tax reported on the 2006 and 2007 amended California returns were discharged, the state tax lien survived bankruptcy.
 7. In December 2017, FTB received a payment through escrow from the sale of appellants' real property and allocated \$45,174.10 to the 2006 tax year and \$14,145.43 to the 2007 tax year.
 8. In December 2018, appellants filed a timely refund claim for both tax years on the basis that the federal adjustments reflected in the 2006 and 2007 California amended returns were erroneous.
 9. FTB denied the refund claims, and this timely appeal followed.

DISCUSSION

If the IRS adjusts a federal tax return, R&TC section 18622(a) requires a taxpayer to report those adjustments to FTB and either concede the accuracy of the federal adjustments or establish why they are incorrect. In a refund action, the taxpayer must prove not only that FTB's determination is incorrect, but also the correct amount of tax owed. (*Appeal of Li*, 2020-OTA-095P.) Unsupported assertions are insufficient to satisfy a taxpayer's burden of proof. (*Ibid.*)

2006 Tax Year

For the 2006 tax year, the IRS determined that appellants underreported their proceeds from the sale of securities by \$268,437 and did not allow a corresponding tax basis in those securities due to lack of substantiation. Appellants concede that they do not have brokerage statements to substantiate their tax basis in the unreported securities. Appellants ask OTA to estimate their basis in the unreported sales based on (1) their pattern of purchasing and selling securities in 2005, 2006, and 2007, and (2) the IRS's acceptance of their basis in other securities sold in 2006 and 2007. Appellants contend that their basis should be estimated as at least half of the proceeds from the unreported sale of securities.

The gain from the sale or other disposition of property is equal to the excess of the amount realized over adjusted basis. (Internal Revenue Code, § 1001(a); R&TC, § 18031.) Taxpayers must establish their basis in securities to determine the amount of gain that must be recognized. (*Wright v. Commissioner*, T.C. Memo. 2007-50.) Taxpayers who fail to establish their basis in securities are considered to have a zero basis. (*Arnold v. Commissioner*, T.C. Memo. 2003-259; *Karara v. Commissioner*, T.C. Memo. 1999-253.)

The *Cohan* rule may be used to estimate a taxpayer's basis in an asset at the time of sale. (*Cohan v. Commissioner* (2d Cir. 1930) 39 F.2d 540; *Group Admin. Premium Servs., Inc. v. Commissioner*, T.C. Memo. 1996-451.) *Cohan* and its progeny hold that "if a taxpayer proves that he [or she] is entitled to a tax benefit but does not substantiate the *amount* of the tax benefit, the court 'should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his [or her] own making.'" (*Shami v. Commissioner* (5th Cir. 2014) 741 F.3d 560, 568, italics in original, citing *Cohan, supra*, 39 F.2d at p. 544.) The taxpayer must first provide some "reasonable evidentiary basis" for the estimation. (*Group Admin. Premium Servs., Inc., supra*; *Namyst v. Commissioner*, T.C. Memo. 2004-263, affd. (8th Cir. 2006) 435 F.3d 910.)

Appellants have not provided a reasonable evidentiary basis for OTA to estimate their basis in the unreported securities. The record does not indicate what securities appellants unreported in 2006, when they purchased those securities, or how appellants' purchase and sale of other securities in other years establish their basis in the unreported securities. The stock market is highly volatile and the purchase and sale of one security does not provide a reasonable

evidentiary basis in this case to estimate appellants' basis in other securities. Accordingly, appellants have not established that they are entitled to a refund for the 2006 tax year.

2007 Tax Year

For the 2007 tax year, appellants contend that they should either be allowed their full COGS based on bank statements and deposit slips they provided to OTA on appeal, or some reasonable percentage based on COGS that the IRS allowed for the same activity for the 2006 tax year. The record shows that the IRS allowed the full amount of reported COGS for the 2006 tax year, \$152,946, after reviewing business bank statements, an itemized list of expenses, and receipts, as well as sampling and verifying over 100 expenses. Appellants claim that they did not provide the same information to the IRS for the 2007 tax year because they were planning to file for bankruptcy and wanted to close the audit without contesting the 2007 adjustment.

COGS for a tax year equals the sum of beginning inventory and purchases (and other acquisition or production costs) during the tax year less ending inventory. (Treas. Reg. §§ 1.471-3(a), (b); 1.471-11; 1.471-1; R&TC, § 24701.) Inventories should be recorded in a legible manner, properly computed, and summarized, and these inventory records must be preserved as part of the accounting records of the taxpayers. (Treas. Reg. § 1.471-2(e).)

Taxpayers are entitled to COGS if they establish their inventory or net sales. (*Petzoldt v. Commissioner* (1989) 92 T.C. 661, 698.) COGS may be estimated under a variation of the *Cohan* rule, even when COGS is not fully substantiated, provided that there is a rational basis for making such an estimate. (*Purple Heart Patient Ctr., Inc. v. Commissioner*, T.C. Memo. 2021-38 [U.S. Tax Court found a rational basis to estimate COGS under the *Cohan* rule based solely on imprecise but credible testimony regarding a markup factor].) As noted above, if a taxpayer is able to demonstrate that the taxpayer paid or incurred an expense, but cannot substantiate the precise amount, the *Cohan* rule generally allows estimating the amount of the expense, while “bearing heavily . . . upon the taxpayer whose inexactitude is of his [or her] own making.” (*Purple Heart Patient Ctr., Inc. v. Commissioner*, *supra*, citing *Cohan*, *supra*, 39 F.2d at p. 544; see also *Goldsmith v. Commissioner* (1958) 31 T.C. 56, 62 [applying the *Cohan* rule to COGS].)

Here, although the record does not provide a rational basis to estimate appellants' beginning and ending inventory figures under the *Cohan* rule, appellants have provided a rational basis to estimate their net sales for South County Distributing for the 2007 tax year. (*Petzoldt v.*

Commissioner, supra, 92 T.C. at p. 698 [taxpayers are entitled to COGS if they establish their inventory *or* net sales].)

The IRS increased South County Distributing's gross sales on audit to \$318,400 for the 2006 tax year and \$205,964 for the 2007 tax year. The record also shows that the IRS examined COGS for the 2006 tax year and allowed the full amount of reported COGS, \$152,946, after reviewing business bank statements, an itemized list of expenses, and "a massive box full of the original receipts."

The IRS audit workpapers show that South County Distributing had "numerous vending machines all around the coast area" in 2006 and 2007 and that appellant-husband "drives to them and different offices to collect monies, stock the machines or sell the other products." The IRS audited COGS for the 2006 tax year and, after reviewing a "massive box full of the original receipts," found that most purchases were made at stores such as Sam's Club, Candy Man, Mama's Sandwiches, and Smart & Final. It is therefore rational to conclude that the vending machines were stocked with perishable items during the 2006 tax year. The audited gross sales and expenses for the 2006 tax year provide a reasonable evidentiary basis to conclude that appellants purchased similar perishable items in 2007 to generate the \$205,964 of gross sales that the IRS determined the vending machines generated in 2007. In further support that South County Distributing paid COGS in 2007, appellants submitted South County Distributing's business bank statements on appeal showing business expenses totaling \$282,733.50 for the 2006 tax year and \$200,123.10 for the 2007 tax year.

As audited by the IRS, the COGS to gross sales ratio for the 2006 tax year is 48.04 percent rounded ($\$152,946.00 / \$318,400.00$). OTA finds that this ratio provides a rational basis to estimate appellants' COGS for the 2007 tax year. Applying this ratio to the 2007 tax year, OTA finds that appellants are entitled to COGS of \$98,936.46 (48.04 percent x \$205,964.00 of gross sales as adjusted by the IRS).

HOLDING

Appellants have not established that they are entitled to a refund for the 2006 tax year. Appellants have established that they are entitled to a refund for the 2007 tax year resulting from an allowance of \$98,936.45 of COGS for South County Distributing.

DISPOSITION

FTB’s action for the 2006 tax year is sustained. FTB’s action for the 2007 tax year is modified to allow a refund resulting from an allowance of \$98,936.45 of COGS for South County Distributing.

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Ovsep Akopchikyan
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Ovsep Akopchikyan
Administrative Law Judge

We concur:

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Josh Lambert
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Josh Lambert
Administrative Law Judge

DocuSigned by:
Richard Tay
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Richard Tay
Administrative Law Judge

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