OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	OTA Case No. 21129284
J. WU	

OPINION

Representing the Parties:

For Appellant: J. Wu

For Respondent: Christopher M. Cook, Attorney

K. WILSON, Hearing Officer: Pursuant to Revenue and Taxation Code (R&TC) section 19045, J. Wu (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing additional tax of $3,875, and applicable interest for the 2016 tax year.

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

ISSUE

Whether appellant has shown any error in FTB's proposed assessment of additional tax for the 2016 tax year, which is based on a final federal determination.

FACTUAL FINDINGS

1. Appellant timely filed a 2016 California Resident Income Tax Return. On her Schedule C, Profit and Loss From Business, appellant reported her principal business or profession as "Information Design, Information Services" and reported that she started the business in 2016. Appellant reported zero gross receipts and business expenses totaling $59,045, including car and truck expenses, travel expenses and other expenses.
2. Subsequently, the IRS audited appellant's federal income tax return and made various adjustments including adjustments to appellant's business expenses.

3. Based on the IRS information, FTB issued a Notice of Proposed Assessment (NPA) on October 19, 2020, that applied the federal adjustments to appellant's 2016 California Income Tax Return. The NPA increased appellant's 2016 California taxable income by $41,668, which consisted of disallowed car and truck expenses of $7,968, disallowed other expenses of $15,470, and disallowed travel expenses of $18,230. The NPA proposed additional tax of $3,875, plus applicable interest.
4. Appellant protested the NPA.
5. FTB issued a Notice of Action affirming the NPA.
6. This timely appeal followed.
7. During the appeal, appellant provided the following documentation in support of the claimed expenses:
    a. An explanation memo, a spreadsheet listing car and truck expenses, two partial Firestone invoices showing services and mileage in January 2015 and November 2016.
    b. An explanation memo, a spreadsheet listing travel and meal expenses, airline receipts and hotel receipts/confirmations associated with weddings, taxi receipts, and meal receipts.
    c. An explanation memo, a spreadsheet listing other expenses, such as education and amortization, a receipt for custom journals, and an iPhone receipt.[1]

DISCUSSION

R&TC section 18622(a) provides that a taxpayer must either concede the accuracy of a final federal determination or state wherein it is erroneous. A deficiency assessment based on federal adjustments to income is presumptively correct and the taxpayer bears the burden of proving that the determination is erroneous. (*Appeal of Dillahunty*, 2024-OTA-024P.) In the absence of credible, competent, and relevant evidence showing that FTB's determination is incorrect, it must be upheld. (*Appeal of Black*, 2023-OTA-023P.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof with respect to a deficiency assessment based on a federal action. (*Appeal of Dillahunty*, *supra*.)

[1] The opinion does not address the custom journals and iPhone since these items were not part of the other expenses disallowed by the IRS.

In this appeal, FTB based its proposed assessment on a final federal determination after an IRS audit. To prevail in this appeal, appellant must show that either the IRS reduced or cancelled appellant's federal assessment disallowing expenses and deductions, or, regardless of the federal action, appellant is entitled to the disallowed amounts. (*Appeal of Dillahunty*, *supra*.) Appellant's 2016 IRS Account Transcript shows that the IRS did not reduce or cancel the federal assessment. Therefore, the Office of Tax Appeals (OTA) next examines whether appellant has shown that FTB's adjustments are incorrect or inapplicable.

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. (*Appeal of Vardell*, 2020-OTA-190P.) To sustain his or her burden of proof, a taxpayer must be able to point to an applicable deduction statute and show that he or she came within its terms. (*Appeal of Dandridge*, 2019-OTA-458P.) Unsupported assertions cannot satisfy a taxpayer's burden of proof. (*Appeal of Vardell, supra.*)

In determining whether these transactions had a valid business purpose, OTA considers whether appellant was engaged in a trade or business such that she was entitled to the claimed business expense deductions. (*Appeal of La Rosa Capital Resources, Inc.* 2020-OTA-220P.) Internal Revenue Code (IRC) section 162(a), which is incorporated into California law by R&TC section 17201, authorizes a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ." (See also *Roberts v. Commissioner*, T.C. Memo. 2012-197 (*Roberts*).) The expenses must be both ordinary and necessary business expenditures directly related to the taxpayer's trade or business. (*Deputy v. du Pont* (1940) 308 U.S. 488, 497; Treas. Reg. § 1.162-1(a).) Further, to be engaged in a trade or business: (1) the taxpayer's primary purpose for engaging in the activity must be for income or profit, (2) the taxpayer must be involved in the activity with continuity and regularity, and (3) the taxpayer's business operations must have commenced. (*Appeal of La Rosa Capital Resource, Inc.*, *supra*.) A taxpayer has the burden of showing that a particular expense is not a personal, living, or family expense. (*Heineman v. Commissioner* (1984) 82 T.C. 538, 542.) A taxpayer is required to keep books and records sufficient to establish matters reported on a return. (*Higbee v. Commissioner* (2001) 116 T.C. 438, 440.)

R&TC section 17201 also incorporates IRC section 274(d). The version of IRC section 274(d) in effect for California personal income tax purposes for the 2016 taxable year

prohibited an IRC section 162 deduction for the following types of expenses, unless they were substantiated by adequate records or sufficient corroborating evidence: (1) any travel expense, including meals and lodging away from home; (2) any item with respect to an activity in the nature of entertainment, amusement, or recreation; (3) an expense for gifts; or (4) the use of "listed property," as defined in IRC section 280F(d)(4), which includes passenger vehicles. (See also *Roberts*, *supra*.) 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 1398,1401.) The tax court has held that "[r]eceipts often fail as proof because they do [not] show any particular business purpose." (*H&M, Inc. v. Commissioner*, T.C. Memo. 2012-290, fn. 17.) Expenses related to other kinds of deductions can sometimes be estimated under the "*Cohan* rule" that was announced in *Cohan v. Commissioner* (2d. Cir. 1930) 39 F.2d 540, but the *Cohan* rule is superseded by the more stringent requirements for deductions under IRC section 274(d). (Treas. Reg. § 1.274-5T(a)(4).)

On appeal, appellant asserts that she is self-employed, doing business as Intelligentsia Silicon Valley, as a photography/wedding photography business and design consultancy. Appellant contends that she is entitled to deduct ordinary and necessary business expenses, including the following, which remain in dispute: car and truck expenses of $7,968, travel expenses of $18,230, and other expenses of $15,470 (business education of $14,500 and amortization of $970).

Car and Truck Expenses

IRC section 274(d) requires a taxpayer to substantiate expenses by adequate records or other corroborating evidence of: (1) the amount of each use (here, the mileage); (2) the time and place of the use; and (3) the business purpose of the use. Listed property expenditures include "the cost of acquisition, the cost of capital improvements, lease payments, the cost of maintenance and repairs, or other expenditures . . . ." (Treas. Reg. § 1.274-5T(b)(6)(i)(A).) The U.S. Tax Court explains that, "[g]enerally, expenses subject to the strict substantiation requirements of [IRC] section 274(d) must be disallowed in full unless the taxpayer satisfies every element of those requirements." (*Fleming v. Commissioner*, T.C. Memo. 2010-60, at p. *2.)

Taxpayers will have maintained "adequate records" if they maintain a log or diary, combined with supporting documents, which substantiate the required elements of the expense, such as the amount, date, and business purpose of the item. (Treas. Reg. § 1.274-5T(c)(2)(i).) For listed property such as a vehicle, the record must contain sufficient information as to each element of every business/investment use in order to constitute "an adequate record (within the meaning of section 274(d)) . . . ." (Treas. Reg. § 1.274-5T(c)(2)(ii)(C)(1).) With the exception of certain documents created on computers, an adequate record must be in writing. (Treas. Reg. § 1.274-5T(c)(2)(ii)(C)(2).) In general, "the taxpayer may establish the date of each trip with a receipt, record of delivery, or other documentary evidence." (Treas. Reg. § 1.274-5T(c)(2)(ii)(C)(1).) "However, the level of detail required in an adequate record to substantiate business/investment use may vary depending upon the facts and circumstances." (*Ibid*.) A taxpayer may choose to deduct actual business-related vehicle expenses or to use the optional standard mileage rate. (Treas. Reg. § 1.274-5(j)(2).) Whether a taxpayer chooses to use actual vehicle expenses or the optional standard mileage rate, "[t]he taxpayer will not be relieved of the requirement to substantiate the amount of each business use (i.e., the business mileage), or the time and business purpose of each use." (*Ibid*.)

Appellant did not list any personal miles on the Form 4562 attached to her Schedule C, yet appellant certified that the vehicle was available for personal use during off-duty hours and that appellant did not have another vehicle that was used for personal use. Therefore, based on appellant's own reporting, the vehicle for which deductions were claimed was, at least in part, a personal vehicle. (See *Michaels v. Commissioner* (1969) 53 T.C. 269, 275.) Appellant did not provide a log, which means that appellant must support the claimed business mileage with other documentary evidence such as receipts, odometer readings, emails, and so forth. (Treas. Reg. § 1.274- 5T(c)(2)(ii)(C)(1).)

Appellant provided the following statement: "On an average day, I commute about 30 + miles one way for my business to: meet with potential clients & customers[,] hold and attend partnership meetings[,] collaborate with others for publishing end products[,] and not including long-distance driving for work – to and from event locations (weddings, engagements, events)[.] Locations of constant business-related travel by car, 4-6 times per week: San Francisco, CA to Cupertino, CA (and back)[,] Redwood City, CA to Cupertino, CA (and back)[,] Redwood City, CA to San Francisco, CA (and back), and Redwood City[,] CA to San Jose, CA (and back)[.]"

In addition, appellant provides two service receipts with mileage of 26,740 on January 3, 2015, and 38,255 on November 18, 2016, showing that the vehicle mileage was 11,515 for the approximately two-year period.

However, appellant indicated on the Schedule C that she began her business in 2016, placed her vehicle in service on May 2, 2016, and had total miles of 11,020, 10,520 of which were business miles and 500 were commuting miles. Again, appellant reports zero personal miles despite reporting that the vehicle was first placed in service in May 2016 and that another vehicle was not available for her personal use. Appellant's statement does not provide the actual dates of travel, specific locations, or the specific business purpose for the travel. Moreover, appellant has not supported the statement with any contemporaneous documentation as required by IRC section 274(d), which requires a taxpayer to substantiate the time, place and business purpose of the use. The spreadsheet appellant has submitted has the date, card ending, type, description, and amount for various claimed vehicle related expenditures such as taxi/uber expenses, vehicle repairs and maintenance, insurance, etc. However, the descriptions listed are vague and do not show which clients the expenses pertain to. Appellant failed to provide supporting documentation such a receipts or invoices for these expenses. As noted earlier, appellant may either claim actual expenses or claim mileage, but not both. (Treas. Reg. § 1.2745-(j)(2).) Thus, appellant has not met her burden of showing that she is entitled to the claimed car and truck expenses deduction.

Travel Expenses

Appellant claimed travel expenses of $18,230 for the cost of travel to photograph weddings in Asia, Hawaii, Lake Tahoe, San Diego, Houston, Austin, Chicago, and Montreal, expenses for meals with "prospective clients" in San Francisco and other Bay Area locations, and catering expenses. Under IRC section 274(d)(1), no deduction or credit shall be allowed for any travel expenses including meals and lodging away from home or for any item with respect to an activity in the nature of entertainment, amusement, or recreation unless the taxpayer substantiates those expenses by adequate records. Claimed deductions are further limited on foreign travel by IRC section 274(c). Appellant provided bank statements, some receipts, and a ledger listing items claimed for travel and meals. Appellant fails to provide any documentary evidence of the business purpose of the travel or meals, such as contracts or agreements with the photography customers. Additionally, appellant fails to explain why she was willing to

personally incur such significant travel expenses (exceeding $18,000) for these events located far from appellant's home when she was not receiving payment for her photography services (appellant reports zero gross receipts). As such, appellant has failed to show that these were ordinary and necessary business expenses rather than personal in nature and has failed to meet the strict substantiation requirements of IRC section 274(d)(1). Thus, appellant has not met her burden of showing that she is entitled to the claimed travel expense or meal deductions.

Other Expenses

Appellant claimed other expenses consisting of education expenses of $14,500 and amortization of start-up costs of $970. According to Treasury Regulation section 1.162-5(a)(1), education expenditures made by an individual for education which are not expenditures of a type described in Treasury Regulation section 1.162-5(b)(2) or (3) are deductible as ordinary and necessary business expenses if the education maintains or improves skills required by the individual in his employment or other trade or business. The deduction under the category of expenditures for education which maintains or improves skills required by the individual in his or her employment or other trade or business includes refresher courses or courses dealing with current developments as well as academic or vocational courses provided the expenditures for the courses are not within either category of nondeductible expenditures described in Treasury Regulation section 1.162-5(b)(2) or (3). (Treas. Reg. § 1.162-5(c).)

Educational expenditures described in Treasury Regulation section 1.162-5(b)(2) and (3), are personal expenditures and, therefore, are not deductible as ordinary and necessary business expenses even though the education may maintain or improve skills required by the individual in his employment or other trade or business. (Treas. Reg. § 1.162.5(b)(1).) The first category of nondeductible educational expenses are expenditures made by an individual for education which is required of the taxpayer in order to meet the minimum educational requirements for qualification in the taxpayer's employment or other trade or business. (Treas. Reg. § 1.162-5(b)(2).) The second category of nondeductible educational expenses are expenditures made by an individual for education which is part of a program of study being pursued by the taxpayer which will lead to qualifying the taxpayer in a new trade or business. (Treas. Reg. § 1.162-5(b)(3).)

Appellant has claimed that education in the amount of $14,500 was for a Stanford Graduate School of Business course (building a business). Appellant has not provided receipts

or registration documentation substantiating either the claimed amount paid ($14,500) or the specific course appellant enrolled in. Appellant has not provided any explanation for how the education expense claimed has met the requirements of Treasury Regulation section 1.162-5. Thus, appellant has not met her burden of showing that she is entitled to the claimed education deduction.

Under IRC section 195, which is incorporated into California law by R&TC section 17279, a taxpayer may elect to claim a deduction of any start-up expenditures in the year in which the active trade or business begins in an amount equal to the lesser of the amount of start-up expenditures with respect to the active trade or business, or $5,000, reduced by the amount by which such start-up expenditures exceed $50,000, and the remainder of such start-up expenditures shall be allowed as a deduction ratably over the 180-month period beginning with the month in which the active trade or business begins. (IRC, § 195(b).) The term "start-up expenditure" means any amount paid or incurred in connection with investigating the creation or acquisition of an active trade or business, or creating an active trade or business, or any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business, and which, if paid or incurred in connection with the operation of an existing active trade or business (in the same field as the trade or business referred to in IRC section 195(c)(1)(A)), would be allowable as a deduction for the taxable year in which paid or incurred. (IRC, § 195(c)(1).)

Appellant claimed an amortization deduction for market research. However, appellant has not established that these expenses if incurred are deductible in 2016 as she has not established that the active trade or business began in 2016. Appellant reports zero gross receipts for 2016, and appellant has failed to establish that the business operations actually commenced in 2016. (See *Appeal of La Rosa Capital Resources, Inc.*, *supra*.) In addition, appellant has not provided any evidence or documentation to support the amount. Thus, appellant has not met her burden of showing that she is entitled to the claimed amortization deduction. Accordingly, appellant has not shown any error in the proposed assessment or in the federal determination upon which it was based.

HOLDING

Appellant has not shown any error in FTB's proposed assessment of additional tax for the 2016 tax year, which is based on a final federation determination.

DISPOSITION

FTB's action is sustained.

Signed by:
Kim Wilson
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Kim Wilson
Hearing Officer

We concur:

Signed by:
Natasha Ralston
25F8FE08EF56478...
Natasha Ralston
Administrative Law Judge

DocuSigned by:
Suzanne B. Brown
47F45ABE89E34D0...
Suzanne B. Brown
Administrative Law Judge

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