OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **C. ALLEN (DEC'D)** **A. ALLEN**	)	OTA Case No. 221111958

OPINION

Representing the Parties:

For Appellants: Doris Mason, Representative

For Respondent: Christopher T. Tuttle, Attorney

For Office of Tax Appeals: Tom Hudson, Attorney

S. ELSOM, Hearing Officer: Pursuant to Revenue and Taxation Code (R&TC) section 19045, C. Allen (dec'd) and A. Allen (appellants) appeal an action by the Franchise Tax Board (respondent) proposing additional tax of $7,578, an accuracy related penalty (ARP) of $1,515.60, and applicable interest for the 2011 tax year.

Office of Tax Appeals (OTA) Panel Members Seth Elsom, Steven Kim, and Natasha Ralston held a virtual oral hearing for this matter on January 16, 2025. At the conclusion of the hearing, the record was closed. OTA reopened the record to allow the parties to provide additional briefings. On April 22, 2025, OTA closed the record, and this matter was submitted for decision.

ISSUES

1. Whether appellants have established error in respondent's proposed assessment, which is based on a federal determination.
2. Whether appellants have established a legal basis for the abatement of the ARP.

FACTUAL FINDINGS

1. Appellants jointly filed a 2011 Form 540 California Resident Income Tax Return, reporting on Schedule CA (540) a business loss of $18,570, a rental loss of $49,807, and total tax of $1,443.
2. On December 13, 2012, the IRS opened an examination of appellants' 2011 federal tax return to review Schedule C deductions and Schedule E passive activity loss (PAL) limitations.
3. On December 13, 2013, the IRS completed its examination of appellants' 2011 federal return, resulting in the following adjustments: (1) disallowance of Schedule C deductions in the amounts of $19,373 for costs of goods sold (COGS), $5,428 for car and truck expenses, and $4,828 for other expenses; (2) disallowance of Schedule E deductions in the amounts of $49,807 for a rental loss due to PAL limitations and $10,147 for mortgage interest; (3) an increase of $781 to the self-employment tax deduction; (4) an increase of $94 to interest income; and (5) an increase of $1 in reported social security income. The IRS also imposed an ARP.
4. On January 14, 2014, the IRS notified respondent of its determination.[1]
5. On December 15, 2014, in accordance with the IRS's determination, respondent issued appellants a Notice of Proposed Assessment (NPA) for the 2011 tax year,[2] proposing additional tax of $7,578, an ARP of $1,515.60, and applicable interest.
6. On October 21, 2022, respondent issued a Notice of Action affirming the NPA.
7. This timely appeal followed.
8. On appeal, appellants provide a copy of a 2011 amended return (Form 540X),[3] reporting a $10,147 increase in income, which corresponds with the amount they reported as a mortgage interest deduction on their original return.
9. In the 2011 540X, appellants explained, "while disallowing full consideration for [Schedule E] R/E Loss after Passive Limitation deduction, IRS reduced the loss deduction by $25,000. [Appellants] previous[ly] made a 469.1 Election to have all real

[1] At appeal, respondent provides a FEDSTAR IRS Data Sheet which lists the IRS's audit adjustments to appellants' 2011 federal tax return and specifically states "FTB Received Date: 1 /14 /2024."

[2] Respondent made all adjustments in accordance with the IRS's federal examination with the exception of the $1 increase to appellants' social security income.

[3] The record does not indicate that appellants filed the 2011 Form 540X amended return with respondent.

property interest[s] considered as one based on classification as a Real Estate Professional." Appellants state that they "seek reconsideration of the R/e Professional designation" and that "[the Schedule C] deductions should result in no change."

10. At the oral hearing, appellant A. Allen testified that, during the 2011 tax year, appellant C. Allen provided electrician services to members of his community on a part-time basis. C. Allen also acquired two properties for the purpose of holding them for rent.

11. Appellant A. Allen further testified that appellant C. Allen employed two private contractors to perform work on the rental properties that appellants had acquired, and spent most of the money earned from the electrician business "as compensation to the gentlemen because they were independent contract[ors]."

12. Following the hearing, OTA reopened the record to allow appellants to provide additional information about Schedule C deductions and Schedule E rental losses disallowed by the IRS.

13. Appellants subsequently provided to OTA the following IRS documents: an IRS letter defining the issues under federal examination for the 2011 tax year; IRS information document requests (IDRs); IRS computations of social security tax, self-employment tax, qualified dividends and capital gain tax, alternative minimum tax, and interest; IRS Form 4549 Income Tax Return Changes; an IRS Notice of Deficiency (NOD) letter; an unsigned IRS NOD waiver letter; and a copy a portion from IRS Publication 925 Passive Activity and At-Risk Rules.

DISCUSSION

Issue 1: Whether appellants have established error in respondent's proposed assessment, which is based on a federal determination.

R&TC section 18622(a) provides that a taxpayer shall either concede the accuracy of a final federal determination or state wherein it is erroneous. Respondent's proposed assessment based upon a final federal determination is presumed to be correct, and a taxpayer bears the burden of proving that respondent's determination is erroneous. (*Appeal of Gorin*, 2020-OTA-018P.) Except as otherwise provided by law, the burden of proof requires proof by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(b).) A preponderance of the evidence means that the taxpayer must establish by documentation or other evidence that the circumstances the taxpayer asserts are more likely than not to be correct. (*Appeal of Black*, 2023-OTA-023P.)

Although respondent may base its proposed assessment on a final federal determination to the extent applicable under California law, it is not bound to do so and can conduct an independent investigation. (*Appeal of Black*, *supra*.) Likewise, appellants can establish respondent's proposed assessment based on a final federal determination is incorrect. (*Ibid*.)

Appellants concede on appeal that the mortgage interest deduction was a reporting error and do not dispute respondent's increases to interest income or the self-employment tax deduction. Thus, at issue in this appeal are respondent's adjustments to disallow Schedule C deductions and Schedule E rental losses, and the imposition of the ARP.

Schedule C Deductions

In general, a taxpayer is allowed to deduct business expenses under Internal Revenue Code (IRC) section 162 so long as the expenses are ordinary and necessary and were paid or incurred during the tax year in carrying on any trade or business.[4] 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 the taxpayer is entitled to the deduction claimed. (*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.) Respondent's denial of claimed deductions is presumed correct until the taxpayer has proven his or her entitlement. (*Appeal of Janke* (80-SBE-059) 1980 WL 4988.)

Here, appellant A. Allen testified at the oral hearing that appellant C. Allen was a retired electrician who worked part time "training other young gentlemen . . . .on how to provide those same services" during the 2011 tax year. Appellant A. Allen further testified that appellant C. Allen employed two private contractors to perform work on rental properties that appellants had acquired and spent most of the money earned from the electrician business, "as compensation to the gentlemen because they were independent contract[ors]". With respect to the expenses incurred in the electrician business, appellant A. Allen testified that appellant C. Allen kept records and appellants "were able to substantiate quite a bit" of the reported expenses examined by the IRS.

Following the oral hearing, OTA reopened the record in this appeal to allow appellants to provide information to substantiate their reported Schedule C COGS, car and truck expenses, and other expenses, such as correspondence between appellants and the IRS during the federal examination, the IRS's computation of items adjusted, supporting law, or any other

[4] IRC section 162 is incorporated into California law by R&TC sections 17201 and 24343, except as otherwise provided.

information appellants believe supports the allowance of their Schedule C deductions. On appeal, appellants provided various correspondence from the IRS including IDRs, the 2011 NOD, and associated calculations of tax and gain. This information substantiates only that the IRS examined appellants' reported Schedule C expenses and disallowed them. Under IRC section 274(d)(1), no deduction or credit shall be allowed for any travel expense unless the taxpayer substantiates those expenses by adequate records. Here, appellants have not provided mileage logs, bank statements, or any other records to show that they are entitled to deduct car and truck expenses. Similarly, appellants have not provided invoices, bank statements, or other information to substantiate their reported COGS expense deductions, nor have they provided any explanation or substantiation of their reported "other" expense deductions. Therefore, appellants have not met their burden of proof to establish error in respondent's proposed assessment disallowing appellants' Schedule C deductions. (See *Appeal of Gorin*, *supra*.)

Schedule E Rent Loss

Under both California and federal law, real estate activity is generally considered passive. (IRC, § 469(a); R&TC, § 17561.) California generally conforms to IRC section 469, which prohibits the use of PALs from reducing non-passive activity income. (R&TC, § 17561(a).) A taxpayer's PAL may be deducted only to the extent of income from passive activities, and any unused PALs are suspended and carried forward to future years to offset passive income generated in those years. (See IRC, § 469(b), (d); *Lowe v. Commissioner*, T.C. Memo. 2008-298 at p. *3.) However, as relevant to this appeal, there are two exceptions to the disallowance of PALs incurred from real estate activity. First, under both federal and California law, individual taxpayers may deduct up to $25,000 of PALs attributable to real estate activity against non-passive income if the taxpayer actively participates in the real estate activity. (IRC, § 469(i); R&TC, § 17561(d)(1).) Second, federal law permits the full deduction of PALs incurred by an individual taxpayer engaged in a real property trade or business against non-passive income if the taxpayer materially participates in and exceeds certain thresholds for providing personal services to the trade or business. (IRC, § 469(c)(7)(B)(i), (ii).) California does not conform to the material participation exception. (R&TC, § 17561(a).)

Here, appellants appear to first argue that appellant C. Allen's material participation in the management of their rental properties and appellants' election to group them together as one activity permits the full deduction of the $49,807 rental losses that appellants reported. As stated above, California does not conform to the material participation exception of IRC

section 469(c)(7). (R&TC, § 17561(a).) Thus, appellants' classification of appellant C. Allen as a real estate professional and election to group their rental properties together as a single real estate activity is not relevant to the determination of the amount of PALs deductible under California law. Appellants appear to further argue that they are permitted to deduct at least $25,000 of their reported rental losses under the active participation exception, stating "while disallowing full consideration for . . . . Sch E R/E Loss after Passive Limitation deduction, IRS reduced the loss deduction by $25,000."

Following the oral hearing, OTA reopened the record to allow appellants to provide evidence to prove they incurred and are entitled to deduct the rental loss reported on their 2011 tax return. Appellants submitted some documents, including a federal IDR requesting additional information to support the PAL. However, appellants did not provide any evidence to prove that appellants either incurred a rental loss in the year at issue or carried forward PALs from rental losses incurred in prior years to deduct in the 2011 tax year.

Therefore, appellants have not met their burden of proof to establish error in respondent's determination to limit appellants' PAL deduction in accordance with the federal determination.

Issue 2: Whether appellants have established a legal basis for the abatement of the ARP.

When respondent imposes a penalty, it is presumed to have been imposed correctly. (*Appeal of Steffier*, 2024 OTA-017P.) The taxpayer bears the burden of proving error in respondent's imposition of the ARP. (*Appeal of Dillahunty*, 2024-OTA-024P.) R&TC section 19164 generally incorporates the provisions of IRC section 6662, which provides for an ARP of 20 percent of the applicable underpayment of tax. (See *Appeal of Daneshgar*, 2021-OTA-210P.) As relevant here, the penalty applies to any portion of an 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 tax return for the tax year, over the amount of tax that is shown on the return, reduced by any rebate. (IRC, § 6662(d)(2)(A).) For individual taxpayers, an "understatement" constitutes a "substantial understatement" if the amount of the understatement for the tax year exceeds the greater of $5,000, or 10 percent of the tax required to be shown on the return. (IRC, § 6662(d)(1)(A).)

Appellants were required to report total tax of $9,021 on their 2011 return but reported tax of $1,443. Therefore, appellants' understatement of $7,578 ($9,021 - $1,443) is a substantial understatement because it exceeds $5,000, which is greater than ten percent of the

tax required to be reported on the return, or $902 ($9,021 x 10 percent). As such, respondent properly imposed the 20 percent ARP based on a substantial understatement of income tax.

As relevant here, the ARP shall not be imposed to the extent the taxpayer can show reasonable cause for, and that the taxpayer acted in good faith with respect to, the underpayment of tax. (R&TC, § 19164(d)(1); IRC, § 6664(c)(1).) In general, the determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. (Treas. Reg. § 1.6664-4(b)(1).) Generally, the most important factor is the extent of the taxpayer's effort to assess the proper tax liability. (*Ibid*.) Reasonable cause may include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the taxpayer's experience, knowledge, and education. (*Ibid*.) The kinds of activities that show a reasonable attempt to comply with the tax laws are maintaining records sufficient to support an entitlement to claimed deductions, conducting tax research, and discussing the situation with the IRS, respondent, or tax advisors. (*Goode v. Commissioner,* T.C. Memo. 2006-48; *Gomez v. Commissioner*, T.C. Memo. 1999-94.)

Appellants generally assert that they intended to comply with the law and pay the correct amount of tax due in good faith. However, as stated above, appellants have not provided sufficient records supporting their claimed Schedule C deductions and Schedule E rental losses, or other evidence of their efforts to properly assess their tax liability. Based upon the record in this appeal, OTA is unable to determine whether appellants have demonstrated reasonable cause and acted in good faith with respect to the understatement. Accordingly, appellants have not met their burden of proof to establish reasonable cause for abatement of the ARP.

HOLDINGS

1. Appellants have not established error in respondent's proposed assessment, which is based on a federal determination.
2. Appellants have not established a legal basis for the abatement of the ARP.

DISPOSITION

Respondent's actions are sustained.

Signed by:
Seth Elsom
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Seth Elsom
Hearing Officer

We concur:

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Steven Kim
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Steven Kim
Administrative Law Judge

Signed by:
Natasha Ralston
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Natasha Ralston
Administrative Law Judge

Date Issued: 7/22/2025