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OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Consolidated Appeals of: **BSISO ENTERPRISE LLC;** **J. BSISO AND** **N. BSISO**	)	OTA Case Nos. 221011701, 221011699

OPINION

Representing the Parties:

For Appellants:	Hassan Ahmed, EA
For Respondent:	Parvis T. Iranpour, Attorney Blake Cunningham, Specialist David Hunter, Attorney
For Office of Tax Appeals:	William J. Stafford, Attorney

T. STANLEY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, Bsiso Enterprise LLC (Enterprise), J. Bsiso and N. Bsiso (the Bsisos) (collectively, appellants) make these consolidated appeals from the actions of respondent Franchise Tax Board (FTB) proposing: (1) for Enterprise, additional tax of $207,943, a late-filing penalty of $51,985.75, and applicable interest, for the 2015 taxable year; (2) for the Bsisos, additional tax of $141,462, an accuracy-related penalty of $28,292.40, and applicable interest, for the 2016 taxable year; and (3) for the Bsisos, additional tax of $72,641, an accuracy-related penalty of $14,528.20,[1] and applicable interest, for the 2017 taxable year.[2]

Appellants waived the right to an oral hearing; therefore, the matter was submitted to the Office of Tax Appeals (OTA) on the written record pursuant to California Code of Regulations, title 18, section 30209(a).

[1] On appeal, FTB concedes the accuracy-related penalty for the 2017 taxable year.

[2] The Bsisos assert that they are entitled to a refund of $154,136 for the 2015 taxable year for alleged overpayments. FTB is holding any refundable amounts in suspense until the conclusion of this appeal, at which time the Bsiso's overpayments from the 2015 taxable year will be applied to the Bsiso's outstanding liabilities, and the excess (if any) will be refunded.

ISSUES

1. Must Enterprise recognize pass-through income of $2,502,291 for the 2015 taxable year?
2. Is Enterprise entitled to deduct various business expenses for the 2015 taxable year?
3. Has Enterprise established reasonable cause to abate the late-filing penalty for the 2015 taxable year?
4. Have the Bsisos shown error in FTB's determinations that J. Bsiso received taxable distributions from Enterprise for the 2016 and 2017 taxable years?
5. Are the Bsisos entitled to deduct additional business expenses for Bsiso Trucking for the 2016 taxable year?
6. Have the Bsisos established a basis to abate the accuracy-related penalty imposed for the 2016 taxable year?

FACTUAL FINDINGS

1. Appellant J. Bsiso (Mr. Bsiso), a California resident during the taxable years at issue, was the sole owner of the membership interests in Enterprise.
2. For the 2015 and 2016 taxable years, Enterprise was taxable as a C corporation. For the 2017 taxable year, Enterprise was taxable as an S corporation.
3. At the beginning of taxable year 2015, Enterprise owned a 20 percent ownership interest in Six Oaks Consulting, LLC (Six Oaks), a medical diagnostic laboratory, which was taxed as a partnership for federal income tax purposes. At year-end 2015, Enterprise owned a 10 percent ownership interest in Six Oaks. Enterprise continued to own a 10 percent interest in Six Oaks throughout the 2016 and 2017 taxable years.

Enterprise and the Bsisos' Tax Reporting

4. For the 2015 taxable year, Six Oaks incorrectly issued a Schedule K-1, Partner's Share of Income, Deductions, Credits, etc. (Schedule K-1), to Mr. Bsiso, instead of to Enterprise. Six Oaks later reissued the 2015 Schedule K-1 to Enterprise. The corrected 2015 Schedule K-1 set forth the following amounts allocable to Enterprise: (i) ordinary income of $2,502,291, (ii) tax exempt income and non-deductible expenses totaling $33, and (iii) distributions of $1,550,000.
5. For 2015, FTB calculated Enterprise's accumulated earnings and profits (E&P) as follows: (1) beginning year E&P of $0; (2) plus current year taxable income of

$2,352,291; (3) plus tax-exempt income and non-deductible expenses of $33; (4) less distributions of $76,260; and (5) total E&P at year end of $2,276,064.

6. As of the date briefing for this appeal closed, Enterprise has not filed a 2015 California Corporation Franchise or Income Tax Return.
7. For the 2016 taxable year, Six Oaks issued a Schedule K-1 to Enterprise reporting a distribution of $670,000 to Enterprise during the year.
8. The Bsisos filed timely personal California Resident Income Tax Returns for the 2016 and 2017 taxable years.
9. For the 2016 taxable year, the Bsisos filed an original joint 2016 California income tax return, as well as two amended 2016 California income tax returns. Their second amended California income tax return reported total tax of $1,450.
10. Mr. Bsiso was the sole proprietor of a trucking business, Bsiso Trucking, during the 2016 taxable year. The Bsisos reported Bsiso Trucking income and expenses on a federal Schedule C, Profit or Loss From Business (Schedule C).
11. For the 2017 taxable year, the Bsisos filed a joint California income tax return reporting total tax of $0.

FTB's Audit of Enterprise and the Bsisos

12. FTB audited Enterprise and the Bsisos. During the audit, FTB determined that Enterprise owed California tax for the 2015 taxable year but had not filed a 2015 California return. In addition, FTB determined that the Bsisos owed additional California tax for the 2016 and 2017 taxable years.
13. At the conclusion of the audit, FTB issued a Notice of Proposed Assessment (NPA) to Enterprise for the 2015 taxable year, which determined that Enterprise had: (i) Schedule K-1 income of $2,502,291; and (ii) a deduction of $150,000 for compensation to officers. The 2015 NPA proposed additional tax of $207,943 and a late-filing penalty of $51,985.75.
14. Enterprise's bank balance as of January 1, 2016, and December 31, 2016, totaled $1,323,740, and $816,427, respectively. In 2016, Enterprise had net income of $388 and a distribution of $670,000 from Six Oaks. Based on this information, FTB determined that Enterprise made distributions to the Bsisos during the 2016 taxable year totaling $1,177,701 ($1,323,740 + $388 + $670,000 - $816,427).

15. For 2016, FTB calculated Enterprise's E&P as follows: (1) beginning year E&P of $2,276,064; (2) plus current year taxable income of $4,556; (3) less distributions to the Bsisos of $1,177,701; and (4) total E&P at year end of $1,103,156.[3]

16. For the 2016 taxable year, Mr. Bsiso reported business expenses of $111,410 on Schedule C for Bsiso Trucking. At audit, FTB disallowed $88,083 of those expenses and allowed $23,327. On appeal, FTB concedes that the Bsisos substantiated additional storage fees of $1,990.

17. FTB issued an NPA to the Bsisos for the 2016 taxable year, which adjusted the Bsisos' income as follows: (i) included dividend income of $1,177,313,[4] (ii) included additional income of $15,248, (iii) disallowed expenses of $111,410, and (iv) allowed a deduction of $3,579 for self-employment tax. The 2016 NPA proposed additional tax of $144,471, an accuracy-related penalty of $28,894.20, and applicable interest.

18. For 2017, FTB determined that Enterprise's E&P from the C corporation's prior taxable years totaled $1,103,156[5] and its accumulated adjustments account totaled $5,903. FTB allowed $25,000 for repayment of distributions by the Bsisos to Enterprise substantiated by a bank statement showing a transfer from Mr. Bsiso's personal bank account to Enterprise's bank account, which reduced the amount of the taxable distributions. Thus, Enterprise distributed $823,526 to Mr. Bsiso, which after deducting the nontaxable accumulated adjustments amount of $5,903, resulted in taxable dividend income of $817,623.[6]

19. FTB issued an NPA to the Bsisos for the 2017 taxable year, which set forth the following adjustments: (i) Schedule K-1 income of $6,309,[7] (ii) dividends of $787,204, and (iii) disallowed itemized deductions of $26,469. The 2017 NPA proposed additional tax of $72,641, an accuracy-related penalty of $14,528.20, and applicable interest.

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[3] FTB appears to have made a minor calculation error: $2,276,064 + $4,556 - $1,177,701 = $1,102,919 instead of $1,103,156, a $237 difference. FTB carries over this error to the calculation of Enterprise's 2017 E&P. The error in nominal and does not affect the taxability of distributions at issue here.

[4] It is unclear why FTB included dividend income of $1,177,313 in the NPA, rather than $1,177,701 computed in factual finding 14 above. However, the Notice of Action, corrected the dividend amount to $1,177,701. See factual finding 22 below.

[5] Includes a calculation error of $237, as noted in footnote 3, above.

[6] The NPA for 2017 proposed a taxable distribution of $787,204, and FTB does not seek to increase the amount of the distribution to $817,623.

[7] Appellants have not disputed this adjustment, and it is not addressed further in this Opinion.

Protest, FTB's Protest Determinations, and Appeal

20. In response to the NPAs, appellants filed timely protests.
21. At the conclusion of the protests, FTB issued a Notice of Action (NOA) to Enterprise for the 2015 taxable year, which affirmed the adjustments set forth in the 2015 NPA.
22. FTB issued an NOA to the Bsisos for the 2016 taxable year, which revised the adjustments set forth in the 2016 NPA as follows: (i) dividend income to $1,177,701, (ii) disallowed expenses to $88,083, and (iii) the deduction or self-employment tax to $3,267.[8] The 2016 NOA proposed to assess additional tax of $141,462, an accuracy-related penalty of $28,292.40, and applicable interest.
23. FTB issued an NOA to the Bsisos for the 2017 taxable year which affirmed the 2017 NPA.
24. In response, appellants filed timely appeals. OTA consolidated the appeals.

DISCUSSION

Issue 1: Must Enterprise recognize pass-through income of $2,502,291 for the 2015 taxable year?

Applicable Law

Gross Income

Internal Revenue Code (IRC) section 61, as incorporated into California law by R&TC section 24271(a) defines gross income as "all income from whatever source derived," except as otherwise provided by statute.

Partnership Distributive Shares

California conforms to IRC section 702, pursuant to R&TC sections 24271(b) and 17851. Under IRC section 702(a), each partner must take into account its distributive share of the partnership's gross income including, but not limited to, taxable income or loss, exclusive of items requiring separate computation. (IRC, § 702(a)(8).)

Partnership Distributions

In the case of a distribution by a partnership to a partner: (1) gain is recognized only to the extent that money distributed exceeds the partner's basis immediately before the distribution; and (2) losses are only recognized to the extent of the excess of the partner's basis

[8] FTB did not modify its proposed assessment of additional income of $15,248.

over the amount of the distribution, when the distribution is in liquidation of a partner's interest in a partnership. (IRC, § 731(a)(1), (2).)

Analysis

Six Oaks issued a 2015 Schedule K-1 to Enterprise reporting that Enterprise's distributive share of partnership ordinary business income was $2,502,291, and that $1,550,000 was distributed to Enterprise. Under IRC section 61, the Schedule K-1 income is gross income, and IRC section 702(a) provides that Enterprise is required to fully recognize the $2,502,291, Enterprise's distributive share of the partnership's income, regardless of whether such amount is fully distributed to it.

Appellants argue that only the distribution of $1,550,000 shown on the Schedule K-1 is taxable, not the entire distributive share of ordinary business income of $2,502,291. Appellants further argue that any income required to be recognized should be further reduced by Enterprise's taxes[9] relating to the distributive share of partnership income that Enterprise received from Six Oaks.

However, based on unambiguous law, Enterprise is required to include in its income its entire distributive share of partnership pass-through business income of $2,502,291, regardless of whether such amount was fully distributed to Enterprise, or whether Enterprise paid corporate taxes in relation to the distributive share. (See IRC, § 702; Treas. Reg. 1.702-1(a).) The amount in Box 1 of the Schedule K-1 must be taken into account by Enterprise as its share of pass-through items of the partnership's income, gains, losses, deductions, and credits. (See IRC, § 702.) For the distributions of $1,550,000 shown in Box 19 of Enterprise's Schedule K-1, IRC section 731 governs the recognition of gain or loss on that distribution based on whether it exceeds the adjusted basis of Enterprise's interest in Six Oaks immediately before the distribution. (See IRC, § 731(a).) With respect to taxes paid, to the extent Six Oaks took a deduction for taxes it paid, Enterprise's share of any deductions would be reflected in the amount reported in Box 1 of the Schedule K-1. Enterprise is not entitled to deduct either California income or franchise taxes or federal income taxes it paid in 2015. (R&TC, § 24345(a), (b)(1).)

FTB did not require Enterprise to recognize income from the $1,550,000 distribution, presumably because its basis in Six Oaks exceeded the amount of the distribution. For a distribution by a partnership to a partner, gain is recognized to the extent that any distribution

[9] Although Enterprise did not file a 2015 tax return as of the date briefing closed, it paid federal and California taxes, which appellants assert reduces their distributive share of income.

exceeds the partner's adjusted basis in the partnership immediately before the distribution. (IRC, 731.) Pursuant to IRC section 705(a)(1)(A), Enterprise's basis was increased by its distributive share of income from Six Oaks for the 2015 taxable year. Thus, its basis in Six Oaks pursuant to IRC section 705(a)(1), would have been at least $2,502,291, making the $1,550,000 distribution nontaxable as it was not in excess of Enterprise's basis in Six Oaks. (IRC § 731(a).)

In summary, Enterprise is not required to recognize the distribution of $1,550,000 as income but must fully recognize its pass-through distributive share of Six Oaks' ordinary business income of $2,502,291, as reflected in Box 1 on the Schedule K-1 issued by Six Oaks to Enterprise for the 2015 taxable year.

Issue 2: Is Enterprise entitled to deduct various business expenses for the 2015 taxable year?

As of the date briefing closed for this appeal, Enterprise has not filed a 2015 California tax return. Nevertheless, Enterprise seeks deductions for various business expenses. OTA addresses each such alleged business expense separately below.

Applicable Law

IRC section 162(a) authorizes a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." A trade or business expense is ordinary for purposes of IRC section 162 if it is normal or customary within the particular trade, business, or industry, and is necessary if it is appropriate and helpful for the development of the business. (*Roberts v. Commissioner*, T.C. Memo. 2012-197.) In contrast, personal, living, or family expenses are generally nondeductible. (*Ibid*.; IRC, § 262.)

In certain circumstances, a taxpayer must meet specific, heightened substantiation requirements to be allowed a deduction under IRC section 162. (*Roberts v. Commissioner*, *supra*; see IRC, § 274(d).)[10] IRC section 274(d) requires that the following types of expenses must be 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 automobiles. (*Roberts v. Commissioner*, *supra*.) To qualify for a deduction, the taxpayer must substantiate an expense with adequate records or sufficient evidence to corroborate the taxpayer's own statement as to: (1) the amount of the expense or other item; (2) the time and

[10] For purposes of the Corporation Tax Law, California generally conforms to IRC sections 162 and 274 at R&TC sections 24343(a) and 24443.

place of the travel, entertainment, amusement, recreation, or use of the property, or the date and description of the gift; (3) the business purpose of the expense or other item; and (4) the business relationship to the taxpayer of the persons entertained or receiving the gift. (*Ibid*.; IRC, § 274(d).) The tax court has held that "[r]eceipts often fail as proof because they don't show any particular business purpose." (*H & M, Inc. v. Commissioner*, T.C. Memo. 2012-290, at fn. 17.)

Where the heightened requirements discussed above do not apply, however, a court may allow the deduction of a claimed expense even where the taxpayer is unable to fully substantiate it if the court has an evidentiary basis for doing so. (*Roberts v. Commissioner*, *supra*, citing *Cohan v. Commissioner* (2d Cir. 1930) 39 F.2d 540, 543-544.) This is called the *Cohan* rule. (See *Perry v. Commissioner*, T.C. Memo. 2012-237.) The *Cohan* rule can be summarized as follows: if a taxpayer establishes that it paid or incurred a deductible business expense but does not establish the amount, a court may approximate the amount of the allowable deduction, bearing heavily against the taxpayer whose inexactitude is of its own making. (*Ibid*., citing *Cohan v. Commissioner*, *supra*.)

Analysis

Automobile-related Expenses

Enterprise asserts that various automobile-related expenses totaling $29,037 should be deductible for the 2015 taxable year. Because passenger automobiles are considered listed property under IRC section 280F(d)(4)(i), they are subject to the more stringent substantiation requirements found in IRC section 274(d). (See *Alemasov v. Commissioner*, T.C. Memo. 2007-130.)

Here, Enterprise did not provide mileage logs (or any other documentation) to support that the vehicles at issue were used for business purposes. Appellants argue that the expenses were incurred and therefore should be allowed without presenting evidence other than that some expenditures were made. For automobile expenses, that position is not supported by law. Thus, Enterprise has not met the stringent requirements of IRC section 274(d). Moreover, unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of GEF Operating, Inc.*, 2020-OTA-057P.) Accordingly, Enterprise has not demonstrated that it is entitled to deduct any automobile-related expenses.

Meals

Taxpayers must meet the requirements of IRC section 274(d) for meal expenses incurred while on business travel. (IRC, § 274(d)(1).) Taxpayers may claim a deduction for food and beverages provided the expense "is not lavish or extravagant under the circumstances" and "the taxpayer (or an employee of the taxpayer) is present at the furnishing of such food or beverages." (IRC, § 274(k)(1).) On the other hand, no deduction is allowed for "personal, living, or family expenses." (IRC, § 262(a).)

Meals are generally considered personal expenses. (*Fife v. Commissioner* (1980) 73 T.C. 621 (*Fife*).) Unless an employee is away from home on business-related travel (within the meaning of IRC section 162(a)(2)), the cost of an employee's meals is generally not deductible under IRC section 162. Travel away from home includes overnight trips and trips requiring sleep or rest. (*U.S. v. Correll* (1967) 389 U.S. 299.) Additionally, for business meals, no deduction is allowed if the food or beverages are lavish or extravagant under the circumstances and if the taxpayer is present at the furnishing of such food or beverages. (IRC, § 274(k)1).)

Appellants assert that they incurred meal expenses of $1,743 and snack expenses totaling $171 for the 2015 taxable year. Enterprise further asserts that Mr. Bsiso met with prospective investors over lunch and dinner to discuss business matters, such as investments into Enterprise.

However, Enterprise has not provided documentation substantiating that the meals and snacks at issue were for business purposes. Moreover, *Fife*, *supra*, held that even where a taxpayer is seeking new clients or having meals with established clients, the essentially personal nature of the taxpayer's meals remains unchanged. Although appellants provided some meal receipts, those standing alone are not sufficient to meet the heightened standard to show the business purpose of the meals or snacks or the relationship of the recipient to Enterprise. (See *H & M, Inc. v. Commissioner*, *supra*.) Thus, Enterprise has not demonstrated it met the stringent requirements of IRC section 274(d). Accordingly, Enterprise is not entitled to deduct meal and snack expenses for the 2015 taxable year.

Donations and Gifts

Appellants contend that Enterprise was the donor of certain specified gifts and should be able to deduct those contributions. However, receipts for the donations appellants provided show Mr. Bsiso was the donor of the gifts, not Enterprise. Accordingly, Enterprise may not deduct the claimed donations and gifts for the 2015 taxable year.

Agent and Mailbox Fees

Appellants assert that Enterprise paid an "agent fee" of $235 for the 2015 taxable year. In support, appellants provide a statement referencing an invoice from "Company Corporation" to Mr. Bsiso's brother. A copy of such invoice, however, is not attached to Enterprise's appeal letter and is not in the appeal record—and Enterprise has not provided evidence (such as a cancelled check, etc.) showing that it paid any such invoice. Appellants assert that an additional $210 should be deductible by Enterprise for mailbox fees. However, FTB reviewed the supporting documentation for this fee and partially allowed Mr. Bsiso a deduction claimed on federal Schedule C, which cannot also be deducted by Enterprise. Accordingly, Enterprise is not entitled to deduct the agent fee of $235 or the mailbox fee of $210 for the 2015 taxable year.

Issue 3: Has Enterprise established reasonable cause to abate the late-filing penalty for the 2015 taxable year?

California imposes a penalty for the failure to file a return on or before the due date, unless it is shown that the failure is due to reasonable cause and not due to willful neglect. (R&TC, § 19131.) When FTB imposes a penalty, the law presumes that the penalty was imposed correctly, and the burden of proof is on the taxpayer to establish otherwise. (*Appeal of Xie*, 2018-OTA-076P.) To overcome the presumption of correctness attached to the penalty, a taxpayer must provide credible and competent evidence supporting a claim of reasonable cause; otherwise, the penalty cannot be abated. (*Ibid*.) To establish reasonable cause, a taxpayer must show that the failure to file a timely return occurred despite the exercise of ordinary business care and prudence, or that cause existed as would prompt an ordinarily intelligent and prudent businessperson to have so acted under similar circumstances. (*Appeal of GEF Operating, Inc*., *supra*.)

Enterprise's 2015 California corporation return was due on March 15, 2016; however, Enterprise has not filed a return as of the date briefing closed. (See R&TC, § 18601(a).)[11] Therefore, FTB imposed a late-filing penalty computed at the maximum of 25 percent of the unpaid tax. (R&TC, § 19131(a).) Because Enterprise's tax liability for the 2015 taxable year was determined to be $207,943, FTB correctly calculated and imposed a late-filing penalty of $51,985.75.

[11] OTA applies the version of R&TC section 18601(a) in effect for the 2015 taxable year at issue here. That version provides that every taxpayer subject to the tax imposed by Part 11 (Corporation Tax Law) shall file a return with FTB on or before the 15th day of the third month following the close of its taxable year. The current version of R&TC section 18601(a), effective January 1, 2017, requires returns to be filed on or before the 15th of the fourth month following the close of the taxable year.

Enterprise asserts reasonable cause based on many factors that have no bearing on the filing of the return. Specifically, Enterprise argues that because Six Oaks erroneously issued the original Schedule K-1 to Mr. Bsiso instead of to Enterprise, Mr. Bsiso had to amend his 2015 personal income tax return many times and it took the IRS more than two years to correct Mr. Bsiso's federal return. In addition, Enterprise asserts that it could not file a return because FTB had not refunded Mr. Bsiso's overpayment of $157,152 claimed on an amended tax return for taxable year 2015.

Those circumstances, however, do not indicate why Enterprise could not timely file its 2015 California corporation return by the due date of March 15, 2016. Enterprise does not explain how Mr. Bsiso's need to amend his 2015 tax return caused Enterprise to fail to file its own return, even to this day. When Six Oaks incorrectly issued the Schedule K-1 to Mr. Bsiso, it was reasonable for Enterprise to believe that it had no taxable income as it was incorrectly attributed to Mr. Bsiso. However, once Six Oaks corrected the Schedule K-1 and issued it to Enterprise, Enterprise's continued failure to file its return is unreasonable. Moreover, Enterprise has not established how a lack of a personal refund to Mr. Bsiso prevented Enterprise from filing its 2015 return. Therefore, Enterprise has not established reasonable cause to abate the late-filing penalty imposed on it for the 2015 taxable year.

Issue 4: Have the Bsisos shown error in FTB's determination that Mr. Bsiso received taxable distributions from Enterprise for the 2016 and 2017 taxable years?

2016 Taxable Year

As applicable to a C corporation, any portion of a distribution constituting a dividend (as defined in IRC section 316) shall be included in gross income. (IRC, § 301(c)(1); R&TC, § 17321.) Dividend means any distribution of property made by a corporation to its shareholders: (1) out of E&P accumulated after February 28, 1913; or (2) out of its E&P of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the E&P at the time the distribution was made. (IRC, § 316(a); R&TC, § 17321.) In general, a distribution of property made by a corporation to a shareholder with respect to its stock that is not a dividend shall be applied against and reduce the adjusted basis of the stock and any amount in excess of the adjusted basis of the stock shall be treated as gain from the sale or exchange of property. (IRC, § 301(c)(2), (3).)

For the 2016 taxable year, FTB determined that Enterprise made a taxable distribution to Mr. Bsiso of $1,177,701. The distribution amount is computed as the reduction during the 2016

taxable year to Enterprise's bank account which had a beginning balance of $1,323,740 and ending balance of $816,427, increased by Enterprise's reported net income (excluding depreciation) of $388 and the distribution of $670,000 by Six Oaks to Enterprise.

The Bsisos assert that certain expenses totaling $180,741 should be deducted from the distribution income: charitable donations of $27,045, credit card payments of $64,272 for business expenses such as gasoline and car maintenance, meals, tolls, etc., and auto lease payments of $17,424. The Bsisos also contend that the distribution should be offset by a "personal deposit" of $51,462, allegedly made by Mr. Bsiso's brother to Enterprise, and by additional payments made to Enterprise from various sources in 2017 and 2018 totaling $808,401, of which FTB allowed $25,000 for a 2017 transfer from Mr. Bsiso's personal bank account to Enterprise.

Enterprise's bank statements, Enterprise's tax return reporting net income (excluding depreciation) of $388, and the 2016 Six Oaks Schedule K-1 reporting a distribution to Enterprise of $670,000 support a finding that Enterprise distributed amounts totaling $1,177,701 to Mr. Bsiso for the 2016 taxable year. Accordingly, the disbursement of $1,177,701 for the 2016 taxable year was a taxable dividend to Mr. Bsiso pursuant to IRC sections 301 and 316. OTA's record shows that Enterprise had E&P in excess of the $1,177,701 distribution. Specifically, FTB calculated that Enterprise had E&P of $2,276,064 at the beginning of 2016, increased by taxable income of $4,556, resulting in E&P of $2,280,620 which was well in excess of the distribution of $1,177,701. The Bsisos have not shown error in FTB's calculation. Furthermore, the Bsisos have not shown that the expenses of $108,741 were paid by Enterprise and had a business purpose, rather than personal expenses paid by the Bsisos. Lastly, the Bsisos have not established how their alleged repayment of the distributed funds in future taxable years affects the taxability of the distributions for 2016. Therefore, the Bsisos have not demonstrated error in FTB's determination that the Bsisos received a taxable distribution of $1,177,701 in 2016.

2017 Taxable Year

As noted above, IRC section 301, in conjunction with IRC section 316, provides the definition of corporate distributions. For an S corporation, however, the taxability of a corporate distribution is determined pursuant to IRC section 1368(a), which provides that a distribution of property with respect to its stock to which (but for this subsection) IRC section 301(c) would apply shall be treated in the manner provided in IRC section 1368(b) or (c), which ever

applies.[12] Under that provision, for an S corporation which has no accumulated E&P, the distribution is not included in gross income to the extent that it does not exceed the adjusted basis of the stock, but where the distribution exceeds the adjusted basis of the stock, such excess shall be treated as gain from the sale or exchange of property. (IRC, § 1368(b)(1), (2).) Where the S corporation has accumulated E&P: (1) the portion of the distribution that does not exceed the accumulated adjustments account is treated in the manner provided by IRC section 1368(b); (2) the remaining portion of the distribution (after application of IRC section 1368(b)) is treated as a dividend to the extent it does not exceed the accumulated E&P of the S corporation; and (3) any remaining portion is treated in the same manner as provided by IRC section 1368(b). (IRC, § 1368(c)(1)-(3).)

For the 2017 taxable year, Enterprise elected to be taxed as an S corporation. During that year, Enterprise distributed $823,526 to Mr. Bsiso. Enterprise's accumulated E&P from the C corporation's prior taxable years was $1,103,156 ($2,276,064 beginning of the year E&P + $4,556 taxable income for 2016 – $1,177,701 taxable distributions during 2016). Enterprise's accumulated adjustments account totaled $5,903 (retained earnings reflected on Enterprise's balance sheet), which amount was nontaxable. Since Enterprise's E&P exceeded the remaining disbursements of $817,623,[13] that amount was taxable as a dividend pursuant to IRC section 1368(c)(2). The Bsisos have not established error in FTB's calculation.

Like the 2016 taxable year, the Bsisos claim that the distribution should be offset by $131,160.64 in expenses paid (presumably by the Bsisos on Enterprise's behalf) and deposits into Enterprise's account totaling $242,602.24 for 2016 through 2018. However as noted above, only one of the claimed deposits ($25,000) was substantiated as a deposit directly from Mr. Bsiso's personal bank account. The Bsisos did not substantiate the sources for the remaining deposits. Like with their 2016 allegations, the Bsisos fail to show that Enterprise actually paid the claimed expenses and that the expenses were for a business purpose, rather than the Bsisos paying personal expenses using corporate distributions. Moreover, the Bsisos have not established that the deposits were repayments of distributions exceeding the $25,000 which the Bsisos substantiated and FTB allowed.

[12] California conforms to IRC Subchapter S relating to the tax treatment of S corporations and their shareholders, except as otherwise provided. (R&TC, § 23800.)

[13] The disbursements of $817,623 exceed the $787,204 FTB proposed to assess in the NPA and NOA. Thus, FTB may not impose additional tax on the $30,419 difference.

In summary, the Bsisos have not demonstrated error in FTB's determinations that Mr. Bsiso receive taxable distributions from Enterprise for the 2016 and 2017 taxable years.

Issue 5: Are the Bsisos entitled to deduct additional business expenses for Bsiso Trucking for the 2016 taxable year?

As discussed above, subject to the limitations and substantiation requirements of IRC section 274, taxpayers may deduct expenses incurred in carrying on any trade or business so long as they are ordinary and necessary expenses for that type of business. (IRC, § 162(a); *Roberts v. Commissioner*, *supra*.)[14] The business expense must be "directly connected with or pertaining to the taxpayer's trade or business[.]" (Treas. Reg. § 1.162-1(a).) Deductions are a matter of legislative grace, and taxpayers bear the burden of proving entitlement to a deduction. (*Appeal of Dandridge*, 2019-OTA-458P.)

Mr. Bsiso was the sole proprietor of a business, Bsiso Trucking, which is reported on a federal Schedule C. For the 2016 taxable year, Mr. Bsiso reported business expenses of $111,410. At audit, FTB disallowed $88,083 of those expenses and allowed $23,327.[15] On appeal, the Bsisos contend that they are entitled to additional deductions for business expenses. OTA addresses each alleged Schedule C expense separately below.

Contract Labor

When a person engaged in a trade or business pays for services in the aggregate amount of $600 in a calendar year, the payor must make an information return and file it with the IRS and with FTB if a California resident provides the services. (IRC, § 6041A; R&TC, § 18631(b), (c)(5).) When a taxpayer fails to file the required information return (typically, a federal form 1099-MISC), FTB may disallow the deduction for remuneration of personal services. (R&TC, § 17299.8)

The Bsisos assert they are entitled to a Schedule C expense deduction of $23,040 allegedly paid for contract labor. At audit, the Bsisos provided four form 1099s totaling $73,220.[16] According to FTB, the forms 1099 were issued to two members of the Bsisos'

[14] For purposes of the Personal Income Tax Law, California generally conforms to IRC sections 162 and 274 at R&TC section 17201(a) and (b).

[15] The protest determination letter dated May 19, 2022, reflects allowed expenses of $23,032; however, the NOA issued to the Bsisos for taxable year 2016 adds back disallowed business expenses of $88,083, which totals allowed claimed expenses of $23,327 ($111,410 - $88,083). The error, if any, is in the Bsisos' favor, and OTA does not address it further.

[16] The forms 1099 are not in OTA's record but are referenced in the protest determination letter issued to the Bsisos for 2016.

household and to two residents of Georgia. The Bsisos provide no evidence that they filed the forms 1099 with the IRS, no evidence substantiating services performed or how those services were related to the trucking business, and no evidence of actual payment. Based on the foregoing, the Bsisos have not proven they are entitled to the disallowed contract labor deductions.

Supplies

FTB allowed a $16 deduction for supplies that it determined to be an ordinary and necessary expense of Bsiso Trucking. On appeal, the Bsisos assert that they are entitled to additional deductions for supplies, however they have not provided any evidence to support this contention. The documents previously provided by the Bsisos do not provide any details substantiating that the claimed supplies were ordinary and necessary for the trucking business. As the Bsisos have not presented any evidence on appeal to substantiate the claimed expenses, they are not entitled to a deduction for supplies beyond what FTB allowed during audit.

Memberships

FTB allowed a $691 deduction for memberships that it determined to be ordinary and necessary expenses of Bsiso Trucking. The Bsisos assert on appeal that they are entitled to deduct claimed membership expenses totaling $1,343, but they have not provided any substantiation to support this contention.

The documents previously provided for FTB's review identified amounts for OnStar service, roadside assistance, Costco membership, and a registered agent fee for Enterprise. FTB found that the OnStar service and roadside assistance appeared to be related to Mr. Bsiso's personal vehicle, and the Bsisos have not shown otherwise. In relation to the Costco membership, the Bsisos have not substantiated that the membership was a business expense, as opposed to a personal expense. In addition, according to FTB, the registered agent fee was for a different business entity and therefore is not deductible on the Bsiso Trucking Schedule C. Accordingly, the Bsisos have not demonstrated that they are entitled to a deduction for membership expenses beyond what FTB allowed during audit.

Taxes and Licenses

FTB allowed a $472 deduction for taxes and license expenses that it determined to be ordinary and necessary expenses of Bsiso Trucking. On appeal, the Bsisos assert that they are entitled to additional deductions for taxes and licenses, but they provide no evidence to support

this contention. The documents provided by the Bsisos at audit identified amounts for TransUnion credit protection, roadside assistance (also deducted as part of memberships), and an expense that was already permitted as part of memberships. The Bsisos have not established that the roadside assistance and credit protection were business expenses, rather than personal expenses, and have therefore not shown that they are entitled to deductions beyond what FTB allowed during audit.

Vehicle

FTB allowed vehicle expenses of $21,703 that it determined to be ordinary and necessary expenses of Bsiso Trucking. On appeal, the Bsisos assert that they are entitled to deduct additional expenses for vehicle, gasoline, and car wash expenses. According to FTB, the documents provided by the Bsisos showed that claimed deductions were for personal expenses that included lease payments on a car purchased for personal use (not business) and insurance on that vehicle. The Bsisos also provided gasoline receipts that identified charges for regular (non-diesel) fuel, which would presumably not be used for the trucking business. On appeal, the Bsisos have not provided evidence showing that such expenses were ordinary and necessary expenses of Bsiso Trucking (and, thus, were not personal expenses) and have not demonstrated that they are entitled to a deduction for vehicle expenses beyond what FTB allowed during audit.

Storage

On appeal, the Bsisos provided a contract, photographs, and a bank statement substantiating that they incurred $1,990 in storage fees to store a truck at Santa Ana RV Storage. Based on the foregoing, FTB concedes storage fees of $1,990. The Bsisos have not provided documentation to substantiate any additional storage fees.

Meals and Entertainment

As discussed above, no deduction is allowed for personal, living, or family expenses. (IRC, § 262(a).) To be deductible, meals are subject to the more stringent IRC section 274(d) substantiation requirements. Further, unless an employee is away from home on business-related travel (within the meaning of IRC section 162(a)(2)), the costs of an employee's meals are not deductible under IRC section 162(a). Travel away from home includes overnight trips and trips requiring sleep or rest. (*U.S. v. Correll*, *supra*, 389 U.S.299.)

FTB disallowed meals and entertainment deductions of $16,741 claimed by the Bsisos on Schedule C. Mr. Bsisos explained to FTB that he incurred the costs for a business purpose

related to selling shares of Enterprise (unrelated to Bsiso Trucking) and presented meal and snack receipts. The receipts, however, show totals paid. They do not provide the business purpose of the expense or the business relationship to the taxpayer of the person entertained. Accordingly, the Bsisos are not entitled to a deduction for meals and entertainment.

Telephone

FTB allowed telephone expenses of $150 that it determined to be ordinary and necessary expenses of Bsiso Trucking. The Bsisos assert that they are entitled to fully deduct the claimed telephone expenses of $4,525. At audit, the Bsisos provided copies of monthly billing statements for more than one cell phone number, a home phone (land line), and a long-distance calling plan. FTB allowed the charges applicable to Mr. Bsiso's cell phone but denied the remainder as personal expenses. The Bsisos have not provided substantiation showing that the remaining expenses were ordinary and necessary expenses of Bsiso Trucking, as opposed to personal expenses. Thus, they are not entitled to a deduction for telephone expenses beyond the amount allowed by FTB during audit.

Lease – Other Business Property (Truck Payments)

The Bsisos claimed a Schedule C expense deduction of $17,430 for rent or lease of a Peterbilt truck. At audit, the Bsisos provided FTB with an invoice showing the truck was purchased in 2008. The Bsisos have not provided (i) evidence of any payments made in 2016, or (ii) an explanation and evidence showing that the purported payments should be considered a truck lease expense of Bsiso Trucking. Accordingly, the Bsisos have not demonstrated that they are entitled to a lease deduction for the 2016 taxable year.

Summary of Expenses

In summary, the disallowed expenses are reduced from $88,083 to $86,093, to reflect storage fees of $1,990, as conceded by FTB on appeal. However, the Bsisos have not otherwise shown error in FTB's determination not to allow additional expense deductions.

Issue 6: Have the Bsisos established a basis to abate the accuracy-related penalty imposed for the 2016 taxable year?

IRC section 6662 imposes a 20 percent accuracy-related penalty on any portion of an underpayment of tax required to be shown on the taxpayer's return if the underpayment is due to negligence, disregard of the rules or regulations, or to a substantial understatement of tax. (IRC, § 6662; R&TC, § 19164.) A substantial understatement of tax exists when the

understatement exceeds the greater of (i) 10 percent of the tax required to be shown on the return, or (ii) $5,000. (IRC, § 6662(d).)

For the 2016 taxable year, pursuant to the 2016 NPA and this Opinion, the Bsisos were required to report California tax of approximately $142,921 but reported only $1,450. The underreporting of approximately $141,462 exceeded both (i) 10 percent of the tax required to be shown on the return, and (ii) $5,000. Accordingly, FTB properly imposed the accuracy-related penalty on the Bsisos for the 2016 taxable year.

An accuracy-related penalty based on a substantial understatement may be abated upon a showing that the understatement was due to a position of the taxpayer on the tax treatment of an item for which there was substantial authority and the taxpayer reasonably believed that such treatment was more likely than not the proper treatment, or where the taxpayer adequately disclosed the relevant facts affecting the tax treatment. (IRC, § 6662(d)(3)(A)-(C).) IRC section 6664(c)(1) provides that an accuracy-related penalty will not be imposed if the taxpayer shows there was a reasonable cause for the underpayment and that the taxpayer acted in good faith with respect to that portion of the understatement. (IRC, § 6664(c)(1).) The determination of reasonable cause for an understatement of tax must consider all pertinent facts and circumstances, with the most important factor being the extent of the taxpayer's effort to assess the proper tax liability. (Treas. Reg. § 1.6664-4(b).)

On appeal, the Bsisos do not argue that they took a position that was supported by substantial authority or a position on the tax treatment of an item that was adequately disclosed. Rather, they argue the penalty should not apply because the understatement was due to a third-party's error, Six Oaks' issuance of the Schedule K-1 to Mr. Bsiso instead of to Enterprise. However, although that argument address why the Bsisos underreported taxable distributions from Enterprise (incorrectly issued 2015 Schedule K-1), the Bsisos have not explained why their records do not support a substantial amount of claimed deductions. The Bsisos have not shown what steps they took to ensure that they accurately reported their 2016 tax. Accordingly, the Bsisos have not established a basis to abate the accuracy-related penalty.

HOLDINGS

1. Enterprise must recognize pass-through income of $2,502,291 for the 2015 taxable year.
2. Enterprise is not entitled to deduct various business expenses for the 2015 taxable year.
3. Enterprise has not established reasonable cause to abate the late-filing penalty for the 2015 taxable year.
4. The Bsisos have not shown error in FTB's determinations that Mr. Bsiso received taxable distributions from Enterprise for the 2016 and 2017 taxable years.
5. Other than storage fees of $1,990 that FTB concedes on appeal, the Bsisos are not entitled to deduct additional business expenses for Bsiso Trucking for the 2016 taxable year.
6. The Bsisos have not established a basis to abate the accuracy-related penalty imposed for the 2016 taxable year.

DISPOSITION

As conceded by FTB on appeal, an additional $1,990 in storage expenses are allowed for the Bsisos for the 2016 taxable year, and the accuracy-related penalty for the 2017 taxable year is abated in full. FTB's action for the 2016 taxable year is modified to adjust the additional tax, accuracy-related penalty, and interest accordingly based on FTB's concession. OTA otherwise sustains FTB's actions in full.

DocuSigned by:
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Teresa A. Stanley
Administrative Law Judge

We concur:

DocuSigned by:
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Asaf Kletter
Administrative Law Judge

DocuSigned by:
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Sara A. Hosey
Administrative Law Judge

Date Issued: 2/17/2026