

1 Neha Garner  
2 Tax Counsel III  
3 Board of Equalization, Appeals Division  
4 450 N Street, MIC:85  
5 P.O. Box 942879  
6 Sacramento, CA 95814  
7 Tel: (916) 323-3094  
8 Fax: (916) 324-2618

6 Attorney for the Appeals Division

7 **BOARD OF EQUALIZATION**  
8 **STATE OF CALIFORNIA**

10 In the Matter of the Appeal of: ) **HEARING SUMMARY**  
11 ) **PERSONAL INCOME TAX APPEAL**  
12 **CESAR Z. LUGO**<sup>1</sup> ) Case No. 790947

		<u>Proposed</u>	
		<u>Assessment</u>	
	<u>Year</u>	<u>Tax</u>	<u>Penalty</u>
	2007	\$ 9,385 <sup>2</sup>	\$ 1,877 <sup>3</sup>

17 Representing the Parties:

18 For Appellant: Cesar Z. Lugo  
19 For Franchise Tax Board: Eric R. Brown, Tax Counsel III

21 **QUESTIONS:** (1) Whether appellant has established error in respondent Franchise Tax Board's  
22 (respondent or FTB) proposed assessment, which is based on a federal  
23 determination; and

25 <sup>1</sup> Respondent issued the proposed assessment to both appellant and his spouse. Each party who files an appeal must sign the  
26 appeal letter and appellant is the only individual who signed the appeal letter. Therefore, we treat this matter as an appeal by  
him alone.

27 <sup>2</sup> The proposed assessment of additional tax has been revised to \$6,571 in accordance with the revised IRS adjustments and  
28 assessment, which respondent stated it discovered after the issuance of the NOA.

<sup>3</sup> This penalty is an accuracy-related penalty. Respondent asserted that it revised the penalty amount to \$1,314.20 in  
accordance with the revised proposed additional tax.

1 (2) Whether appellant has demonstrated that the accuracy-related penalty should be  
2 abated.

3  
4 HEARING SUMMARY

5 Background

6 Appellant and his spouse filed a timely California income tax return, reporting  
7 California adjusted gross income (AGI) of \$142,192, itemized deductions of \$44,033, and California  
8 taxable income of \$98,159. The couple reported a total tax of \$4,743. After accounting for exemption  
9 credits of \$776 and withholding credits of \$1,528, the couple paid their tax liability of \$2,439 with the  
10 submission of their return. (Resp. Opening Br., p. 1-2, Exs. A, B & C.)

11 Subsequently, respondent received information from the Internal Revenue Service  
12 (IRS), which indicated that federal adjustments had been made to the couple's Schedule C on their  
13 2007 return. Of the claimed Schedule C expenses that were adjusted, the IRS disallowed \$4,734.00 in  
14 other expenses, \$8,217.74 in cost of goods sold, \$12,127.00 in advertising, \$25,229.00 in contract  
15 labor, \$3,791.00 in meals and entertainment, and \$11,927.00 in car and truck expenses. In addition,  
16 gross receipts or sales were increased by \$35,333. As a result of the adjustments to Schedule C, \$954  
17 in Schedule A employee business expenses were disallowed, \$1,717 of Schedule A total itemized  
18 deductions were disallowed, and the self-employment tax deduction was increased by \$1,357. The IRS  
19 assessed additional tax of \$30,927.00 and imposed an accuracy-related penalty of \$6,185.40. The  
20 couple did not inform respondent of these adjustments. (Resp. Opening Br., p. 2, Ex. D.)

21 On April 13, 2012, respondent issued a Notice of Proposed Assessment (NPA) and made  
22 corresponding adjustments to the couple's taxable income. Respondent disallowed several Schedule C  
23 deductions, including the following: (1) \$4,734 in other expenses; (2) \$8,218 in cost of goods sold;  
24 (3) \$12,127 in advertising; (4) \$25,229 in contract labor; (5) \$3,791 in meals and entertainment; and  
25 (6) \$11,927 in car and truck expenses. Respondent also added \$35,333 in Schedule C gross receipts,  
26 disallowed \$954 in Schedule A employee business expenses, disallowed \$1,717 in Schedule A total  
27 itemized deductions, and increased the one-half self-employment tax deduction by \$1,357. As a result  
28 of these adjustments, respondent proposed additional tax of \$9,385 and an accuracy-related penalty of

1 \$1,877, plus interest. (Resp. Opening Br., p. 2, Ex. E.)

2 Appellant timely protested the NPA, asserting that his attorney was in the process of  
3 appealing their federal assessment with the IRS. In a letter dated January 9, 2013, respondent  
4 acknowledged that it had received appellant's protest and explained that the couple's AGI and taxable  
5 income had increased as a result of the audit conducted by the IRS. Respondent also advised appellant  
6 and his spouse that recently-received information indicated that the IRS had not canceled or reduced its  
7 assessment, and therefore the NPA was correct. Respondent also explained that, unless it received  
8 information that the federal action was not final or that the IRS had changed or canceled its assessment  
9 by February 11, 2013, respondent would affirm the NPA. (Resp. Opening Br., p. 2, Exs. F & G.)

10 On February 11, 2013, appellant responded to the January 9, 2013, letter from  
11 respondent explaining that the couple was waiting for a decision from the IRS and indicated that the  
12 appeal had been referred to the IRS's Taxpayer Advocate. Appellant requested an additional 90 days  
13 for the IRS to complete its appeal process. By letter dated February 13, 2013, respondent  
14 acknowledged the receipt of appellant's letter and indicated that it would not proceed further with the  
15 appeal for 90 days. Respondent advised that, if it did not receive additional information by May 13,  
16 2013, respondent would affirm the NPA. (Resp. Opening Br., pp. 2-3, Exs. H & I.)

17 On May 1, 2013, appellant again requested an additional 60-day extension in which to  
18 provide additional information. Respondent replied by a letter on May 6, 2013, agreeing to further  
19 withhold proceedings for 60 additional days and advised appellant that, if it did not receive any  
20 additional information to review by July 2, 2013, it would affirm its notice based on the information  
21 then available. (Resp. Opening Br., p. 3, Exs. H, J & K.)

22 On June 19, 2013, appellant requested an additional 60-day extension in which to  
23 provide additional information. Appellant attached a June 17, 2013 letter from the small business  
24 division of the IRS indicating that an appointment had been scheduled with appellant in Santa Maria on  
25 July 17, 2013. Respondent replied by letter on June 24, 2013, agreeing to withhold further proceedings  
26 for 60 additional days and advised appellant that, if it did not receive any additional information to  
27 review by August 20, 2013, respondent would affirm its notice. On August 20, 2013, appellant  
28 indicated that the couple's case was still under review by the IRS and that they were waiting for a

1 decision. (Resp. Opening Br., p. 3, Exs. H, K, L, M & N.)

2 Respondent issued a Notice of Action (NOA) for the 2007 tax year on November 1,  
3 2013,<sup>4</sup> affirming the NPA. Appellant then filed this timely appeal. (App. Opening Br.)

4 Contentions

5 Appellant's Contentions

6 Appellant contends that he is still in the process of appealing the federal action but that  
7 there has not yet been a final federal determination. Appellant contends that the IRS was "shut down,  
8 due to [a] government shut down, for 14 days" and that he assumes that the IRS is trying to get caught  
9 up. Appellant included a copy of a November 6, 2013 letter from the IRS which explained that, due to a  
10 heavy workload, the IRS had not yet completed its research. (App. Opening Br.)

11 Appellant submitted additional information including the following: (1) a letter dated  
12 September 3, 2014, from an IRS Appeals Officer, enclosing an agreement form based on its discussion  
13 with appellant and requesting appellant's signature as to whether he agreed with the proposed  
14 settlement; (2) an IRS "490 Activity Summary" sheet, which indicated an abatement of tax by the  
15 examination division and an abatement of the miscellaneous penalty; (3) IRS Form 3610, Audit  
16 Statement, which indicated an overassessment in the amount of \$9,482; (4) IRS Form 5278, Income Tax  
17 Changes, for the couple's 2007 tax year; (5) IRS Form 6261, Alternative Minimum Tax Computation,  
18 for the couple's 2007 tax year; and (6) IRS Form 870, Waiver of Restrictions on Assessment and  
19 Collection of Deficiency in Tax and Acceptance of Overassessment, which indicated a tax decrease in  
20 the amount of \$9,482. (App. Opening Br., Appellant's Additional Information)

21 Respondent's Contentions

22 Respondent explains that, based on appellant's argument that a federal action was  
23 pending, this Board deferred proceedings on appellant's appeal until recently. On November 6, 2014,  
24 this Board reactivated the appeal and provided respondent with a copy of additional information that  
25 appellant provided on October 24, 2014. Respondent contends that, upon the reactivation of the  
26 proceedings by this Board, respondent obtained an individual master file (IMF) transcript regarding the  
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28 <sup>4</sup> Respondent asserted that it suspended interest for the time period reflected in R&TC section 19116 and that the accrual of interest resumed 15 days after the date of the NPA.

1 couple's federal tax liability for the 2007 tax year. Respondent contends the IRS partially abated the  
2 earlier \$30,927.00 assessment of tax in the amount of \$9,482.00 and partially abated the accuracy-  
3 related penalty in the amount of \$1,896.40 (i.e., 20 percent of \$9,482) for a revised federal penalty of  
4 \$4,289. (Resp. Opening Br., pp. 3-4, Ex. O.)

5 Respondent contends that the federal revisions to Schedule C gross receipts or sales, the  
6 self-employment tax deduction adjustment, and the allowance of \$594.00 in additional itemized  
7 deductions were applicable to the couple's California tax. Respondent asserts that it revised the  
8 proposed assessment of additional tax from \$9,385.00 to \$6,571.00, and adjusted the accuracy-related  
9 penalty from \$1,877.00 to \$1,314.20 (i.e., 20 percent of \$6,571).<sup>5</sup> (Resp. Opening Br., p. 4, Ex. P.)

10 Respondent asserts that, pursuant to Revenue and Taxation Code (R&TC) section 18622,  
11 appellant must concede the accuracy of the federal changes or state wherein the changes are erroneous.  
12 With regard to the proposed assessment based on the federal audit, respondent contends that appellant  
13 failed to meet his burden of proving error in the revised federal changes, or error in respondent's actions  
14 based on those revised federal changes, pursuant to R&TC section 18622. Respondent contends that,  
15 while appellant has submitted evidence of a partial abatement of the federal assessment, he makes no  
16 other arguments nor has he submitted any evidence showing any error on the part of respondent for  
17 making its revised adjustments. Respondent also contends that it is important to note that the federal  
18 documents indicate that appellant agreed to the IRS's partial abatement of tax and partial abatement of  
19 the accuracy-related penalty, as evidenced by entries in the IMF transcript. Respondent specifically  
20 contends that the IMF transcript indicates that appellant agreed with the IRS revisions and that the  
21 agreement was entered into on September 10, 2014. (Resp. Opening Br., p. 4-5, Exs. O & Q.)

22 With respect to the accuracy-related penalty, respondent contends that, when based on a  
23 federal action, its imposition of a penalty is presumptively correct. Respondent asserts that the  
24 accuracy-related penalty was properly imposed under R&TC section 19164 and by reference to IRC  
25 section 6662, as a result of a substantial understatement of income tax or negligence or disregard of the  
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27 <sup>5</sup> Respondent asserts that it called appellant on April 27, 2015, advising appellant of the changes to the couple's tax liability  
28 and indicated that the revisions were in their favor. Respondent asserts that it advised appellant that, if he agreed with  
respondent's revised tax calculation, he could sign an agreement page, and then could dismiss his appeal. (Resp. Opening  
Br., p. 4.)

1 rules. Respondent contends that, in accordance with the IRS, it imposed a 20 percent accuracy-related  
2 penalty and that the IMF transcript did not indicate an abatement of the federal penalty. Respondent  
3 argues that the federal accuracy-related penalty is based on a substantial understatement, which is  
4 defined as the greater of 10 percent of the tax required to be shown on the return for the taxable year, or  
5 \$5,000 pursuant to IRC section 6662(d)(1)(A).

6 Respondent contends that, pursuant to IRC section 6664(c), the penalty may be abated  
7 upon a showing of reasonable cause and good faith, but that appellant has not provided any facts to  
8 suggest that the penalty should be abated because of good cause. Respondent argues that appellant did  
9 not make any arguments regarding the penalty nor did he suggest that good cause existed to abate the  
10 penalty. Respondent contends that the IMF transcript does not indicate that the IRS has abated the  
11 couple's federal accuracy-related penalty and, therefore, appellant has not satisfied his burden of proof.

## 12 Applicable Law

### 13 Burden of Proof

14 Revenue and Taxation Code (R&TC) section 18622 provides that a taxpayer shall either  
15 concede the accuracy of a federal determination or state wherein it is erroneous. It is well-settled that a  
16 deficiency assessment based on a federal audit report is presumptively correct and that a taxpayer bears  
17 the burden of proving that the determination is erroneous. (*Appeal of Sheldon I. and Helen E. Brockett*,  
18 86-SBE-109, June 18, 1986; *Todd v. McColgan* (1949) 89 Cal.App.2d 509.) Likewise, a deficiency  
19 assessment based on a final federal determination resulting from a settlement agreement between the  
20 taxpayer and the IRS is presumed to be correct. (*Appeal of David Chow*, 86-SBE-130, July 29, 1986.)  
21 "The taxpayer cannot merely assert the incorrectness of a determination of a tax or the method used and  
22 thereby shift the burden to the commissioner to justify the tax and the correctness thereof." (*Todd v.*  
23 *McColgan, supra.*) Unsupported assertions are not sufficient to satisfy an appellant's burden of proof.  
24 (*Appeal of Aaron and Eloise Magidow*, 82-SBE-274, Nov. 17, 1982.) Furthermore, while a taxpayer's  
25 claim that he only acquiesced to federal adjustments because of coercion or economic reasons explains  
26 a taxpayer's motivation, it has no bearing on whether the federal determination was correct. (*Appeal of*  
27 *Robert J. and Evelyn Johnston*, 75-SBE-030, April 22, 1975; *Appeal of Ronald J. and Eileen Bachrach*,  
28 80-SBE-011, Feb. 6, 1980; *Appeal of Barbara P. Hutchinson*, 82-SBE-121, June 29, 1982.)

1           While respondent may rely on the findings of the IRS, it is not necessarily bound to  
2 follow a federal action. (*Appeal of Der Weinerschnitzel International, Inc.*, 79-SBE-063, Apr. 10,  
3 1979; *Appeal of Raymond and Rosemarie J. Pryke*, 83-SBE-212, Sept. 15, 1983.) Furthermore, income  
4 tax deductions are a matter of legislative grace, and the burden is on a taxpayer to show by competent  
5 evidence that he is entitled to the deductions he has claimed. (*Appeal of James C. and Monablance A.*  
6 *Walshe*, 75-SBE-073, Oct. 20, 1975.) To carry the burden of proof, a taxpayer must point to an  
7 applicable statute and show by credible evidence that the deductions claimed come within its terms.  
8 (*Appeal of Robert R. Telles*, 86-SBE-061, Mar. 4, 1986.)

9           Accuracy-Related Penalty

10           R&TC section 19164, which incorporates the provisions of Internal Revenue Code  
11 (IRC) section 6662, provides for an accuracy-related penalty of 20 percent of the applicable  
12 underpayment. As relevant to this appeal, the penalty applies to the portion of the underpayment  
13 attributable to (1) negligence or to the disregard of rules and regulations or (2) any substantial  
14 understatement of income tax. (Int.Rev. Code, § 6662(b).) The Internal Revenue Code defines  
15 “negligence” to include “any failure to make a reasonable attempt to comply” with the provisions of the  
16 code. (Int.Rev. Code, § 6662(c).) The term “disregard” is defined to include any “careless, reckless, or  
17 intentional disregard.” (*Ibid.*) IRC section 6662 provides that a substantial understatement of tax exists  
18 if the amount of the understatement exceeds the greater of 10 percent of the tax required to be shown on  
19 the return or \$5,000. (Int.Rev. Code, § 6662(d)(1).) “Understatement” means the excess of the amount  
20 required to be shown on the return for the taxable year over the amount of the tax imposed which is  
21 shown on the return, reduced by any rebate. (Int.Rev. Code, § 6662(d)(2).)

22           There are three exceptions to the imposition of the accuracy-related penalty. Under the  
23 first exception, the penalty shall be reduced by the portion of the understatement attributable to a tax  
24 treatment of any item if there is substantial authority for such treatment. (Int.Rev. Code,  
25 § 6662(d)(2)(B).) Under the second exception, the penalty shall be reduced by the portion of the  
26 understatement attributable to a tax treatment of any item if the relevant facts affecting the item’s tax  
27 treatment are adequately disclosed and there is a reasonable basis for the tax treatment of such item.  
28 (Int.Rev. Code, § 6662(d)(2)(B).) Under the third exception, the penalty will not be imposed to the

1 extent that appellant shows a portion of the underpayment was due to reasonable cause and that he  
2 acted in good faith with respect to such portion of the underpayment. (Int.Rev. Code, § 6664(c)(1);  
3 Treas. Regs. §§ 1.6664-1(b)(2) & 1.6664-4.)

4 A determination of whether a taxpayer acted with reasonable cause and in good faith is  
5 made on a case-by-case basis and depends on the pertinent facts and circumstances, including his  
6 efforts to assess the proper tax liability, his knowledge and experience, and the extent to which he  
7 relied on the advice of a tax professional. (Treas. Reg. § 1.6664-4(b).) Generally, the most important  
8 factor is the extent of the taxpayer's effort to assess his proper tax liability. (*Id.*) The reliance on the  
9 advice of a professional tax advisor does not necessarily demonstrate reasonable cause and good faith.  
10 (*Id.*) However, the reliance on professional advice constitutes reasonable cause and good faith if, under  
11 all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. (*Id.*)

12 The taxpayer bears the burden of proving any defenses, such as substantial authority,  
13 disclosure, and reasonable basis, and reasonable cause and good faith. (*Recovery Group, Inc. v.*  
14 *Comm'r*, T.C. Memo. 2010-76.) An absence of records, due to loss or destruction, cannot in and of  
15 itself establish that a taxpayer's deductions were founded on reasonable cause and good faith when  
16 made. (*Xuncax v. Comm'r*, T.C. Memo. 2001-226.) The alleged mistreatment of a taxpayer by the IRS  
17 is not relevant to whether the taxpayer has established the existence of reasonable cause because the  
18 reasonable cause exception is focused on the taxpayer's actions, not the IRS's actions. (*Moss v.*  
19 *Comm'r* (T.C. 2010) 135 T.C. 365, 373.)

#### 20 STAFF COMMENTS

21 The federal Account Transcript for the year at issue is final, as there are no pending  
22 claims or adjustments. Failure on the part of the taxpayer to provide evidence that is within the  
23 taxpayer's control gives rise to a presumption that such evidence is unfavorable to his position. At the  
24 hearing, appellant should be prepared to provide evidence which demonstrates error in respondent's  
25 determination. Specifically, appellant should be prepared to provide documentation that substantiates  
26 his contention that the federal adjustments are incorrect or that the federal determination is not final.  
27 Appellant should also be prepared to address why he agreed on September 10, 2014, to the IRS's partial  
28 abatement of tax and the partial abatement of the accuracy-related penalty, as evidenced by the IMF

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transcript, and then explain why the federal determination should not now be considered final.

Respondent imposed the 20 percent state accuracy-related penalty attributable to a substantial understatement in accordance with the federal accuracy-related penalty on appellant’s 2007 tax year. The understatement of \$6,571 greatly exceeded 10 percent of the tax required to be shown on the return (i.e., \$10,538.80 x 10% = \$1,053.80) or \$5,000.00. Appellant should be prepared to discuss whether any of the defenses to the imposition of the accuracy-related penalty should apply to this appeal, including whether appellant acted with reasonable cause and good faith. Unless one of the exceptions to the penalty is applicable, it appears that respondent properly imposed the accuracy-related penalty.

Pursuant to California Code of Regulations, title 18, section 5523.6, if either party has any additional evidence to present, it should be provided to the Board’s Board Proceedings Division at least 14 days prior to the oral hearing.<sup>6</sup>

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<sup>6</sup> Evidence exhibits should be sent to: Khaaliq Abd’Allah, Associate Governmental Program Analyst, Board Proceedings Division, State Board of Equalization, P.O. Box 942879 MIC:80, Sacramento, California, 94279-0080.