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10 **BOARD OF EQUALIZATION**
11 **STATE OF CALIFORNIA**

12 In the Matter of the Appeal of:) **HEARING SUMMARY**
13) **PERSONAL INCOME TAX APPEAL**
14 **KEVIN M. KELLY AND**) Case No. 539558
15 **GRETCHEN L. KELLY**)

	<u>Years</u>	<u>Proposed Tax Assessments</u>	<u>Penalty</u>
	2004	\$8,906.00	
	2005	\$6,371.00	
	2006	\$10,838.00	\$2,167.60

16 Representing the Parties:

17 For Appellants: Joyce Rebhun, Attorney at Law
18 For Franchise Tax Board: Cynthia D. Kent, Tax Counsel

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22 **QUESTIONS:** (1) Whether appellants have shown that the determinations of the Franchise Tax
23 Board (FTB or respondent) based on federal audit reports are incorrect.
24 (2) Whether appellants have shown that the accuracy-related penalty imposed against
25 appellants for 2006 should be abated.
26 (3) Whether appellants have shown that interest assessed against appellants should be
27 abated.

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1 HEARING SUMMARY

2 Background

3 Appellants filed timely joint California resident tax returns for tax years 2004-2006.
4 Appellant-husband was a chiropractor, and appellant-wife was allegedly in the real estate business for at
5 least part of that period. On their 2004 return, appellants reported California adjusted gross income
6 (AGI) of \$57,766, total deductions of \$38,493, and a resulting taxable income of \$19,273. Appellants
7 self-assessed tax of \$263 and, after applying their personal exemption credits of \$170, they reported tax
8 liability of \$93. Because they had withholding credits of \$1,992 and estimated tax payments of \$280,
9 appellants had an overpayment for 2004 of \$2,179. In accordance with a request by appellants,
10 respondent applied \$179 of the overpayment to their 2005 tax account and refunded \$2,000 to them.

11 Appellants reported on their return for 2005 California AGI of \$71,738 and total
12 deductions of \$58,516, for a resulting taxable income of \$13,222. Appellants reported self-assessed tax
13 of \$138. After applying their personal exemption credits of \$174, appellants' tax liability was zero.
14 Because they had withholding credits of \$1,760 and an estimated tax payment of \$179, appellants had an
15 overpayment for 2005 of \$1,939. Pursuant to their instructions, respondent transferred \$1,760 to
16 appellants' 2006 tax account and refunded \$179 to them.

17 For 2006, appellants reported on their return California AGI of \$117,859, total
18 deductions of \$58,927, and a resulting taxable income of \$58,932. Appellants reported a self-assessed
19 tax of \$1,783. After applying their personal exemption credits of \$182, appellants' resulting tax liability
20 was \$1,601. Because appellants had withholding credits of \$859 and an estimated tax payment of
21 \$1,760, they had an overpayment for 2006 of \$1,018. Respondent refunded the full amount of the
22 overpayment to appellants.

23 In 2008, respondent received a revenue agent's report (RAR) for each of the appeal years
24 indicating that the Internal Revenue Service (IRS) had audited appellants and made adjustments to
25 appellants' income and claimed itemized deductions that increased appellants' federal taxable income
26 for those years. Respondent states that appellants failed to notify it of those federal adjustments.

27 On March 3, 2009, respondent issued a Notice of Proposed Assessment (NPA) against
28 appellants for 2004. (Resp. Br., Exhibit K.) Following the federal adjustments stated on the RAR and

1 appellants' federal account transcript for 2004, respondent increased appellants' taxable income for
2 2004 by \$121,814. The NPA indicated, with regard to the computation of the foregoing amount, that
3 respondent disallowed the deduction of \$41,491 in claimed expenses on Schedule C of appellants' 2004
4 federal return, increased appellants' income (gross receipts) by \$86,621, and allowed a self-employment
5 tax deduction of \$6,298. After applying appellants' personal exemption credits of \$170 to their revised
6 tax of \$9,169, and taking into account the tax liability of \$93 already reported on appellants' 2004
7 return, respondent proposed the assessment of additional tax in the amount of \$8,906 plus interest.

8 On the same date, respondent also issued an NPA against appellants for 2005. (Resp. Br.,
9 Exhibit N.) Following the federal adjustments stated on the RAR and appellants' federal account
10 transcript for 2005, respondent increased appellants' taxable income for 2005 by \$100,832. With regard
11 to the computation of that amount, the NPA indicated that respondent disallowed medical and dental
12 expenses of \$5,202 claimed on Schedule A of appellants' 2005 federal return as well as claimed
13 Schedule C expenses of \$60,476, increased appellants' income (gross receipts) by \$40,000, and allowed
14 a self-employment tax deduction of \$4,846. After applying appellants' personal exemption credits of
15 \$174 to their revised tax of \$6,545, respondent proposed the assessment of additional tax in the amount
16 of \$6,371 plus interest.

17 On March 23, 2009, respondent issued an NPA against appellants for 2006. (Resp. Br.,
18 Exhibit Q.) Following the federal adjustments stated on the RAR and appellants' federal account
19 transcript for 2005, respondent increased appellants' taxable income for 2005 by \$122,550. That
20 amount is allegedly comprised of the following adjustments: (1) \$18,042 in additional income, (2)
21 \$98,926 in long term capital gain (\$15,042 less than the amount reported on Schedule D of appellants'
22 2006 federal return because of differences between California and federal laws), (3) an increase in
23 income of \$22 resulting from the disallowance of a self-employment tax deduction, (4) an increase in
24 income of \$7,219 resulting from the disallowance of claimed Schedule C expenses, and (5) a decrease in
25 income resulting from allowed Schedule C expenses of \$1,659. (Resp. Br., p. 3, fn. 3.) After applying
26 appellants' personal exemption credits of \$182 to their revised tax of \$12,621, and taking into account
27 the tax liability of \$1,601 already reported on appellants' 2006 return, respondent proposed the
28 assessment of additional tax of \$10,838 plus interest. Respondent also proposed the assessment of an

1 accuracy-related penalty of \$2,167.60 plus interest.

2 Appellants filed a protest with regard to tax years 2004-2006. (Resp. Br., Exhibit S.) In
3 her protest letter, dated April 30, 2009, appellants' current representative criticized the quality of the
4 representation by their former representative during the audits of their returns for 2004-2006.
5 Appellants' representative stated in her letter that appellants had filed amended federal returns for 2004-
6 2006 requesting audit reconsideration and adjustments to their accounts. She also stated that the IRS
7 had acknowledged receiving the amended federal returns and indicated that it was evaluating them.
8 Further, the representative alleged that amended California returns for 2004-2006 would be filed with
9 respondent requesting that the proposed assessments be invalidated. In addition, she alleged that full
10 documentation would be attached to the amended returns supporting (1) the ordinary and necessary
11 business expenses claimed on the original returns, (2) the correct income, which was allegedly not
12 reported by appellants' former representative on their original returns, and (3) the proper treatment of
13 sales of real estate, including the sale of appellants' personal residence.

14 In its letter of reply, dated April 12, 2010, respondent indicated that before it could revise
15 its NPA's, appellants would have to provide documentation from the IRS that their amended federal
16 returns for 2004-2006 had been accepted as filed or a revised federal audit report. Respondent stated
17 that if it did not receive the requested information within 30 days of the date of its letter, it would
18 assume that its NPA's are correct. Respondent alleges that appellants failed to reply to its letter. On
19 July 7, 2010, respondent issued Notices of Action (NOA's) (App. Ltr., Exhibit 1) affirming its NPA's
20 for 2004-2006. This timely appeal followed.

21 Contentions

22 Appeal Letter

23 In their appeal letter, appellants allege that the IRS auditor abused his discretion in
24 making tax assessments against appellants for the years at issue. Appellants also allege that they
25 provided proof to respondent when they filed their protest that the years at issue were then open to
26 federal audit reconsideration. Appellants state in their letter that tax years 2004 and 2005 were before an
27 IRS Appeals Officer and that a hearing would occur in late August 2010. Appellants attached to their
28 letter a copy of a letter, dated May 18, 2010, from an IRS Appeals Office acknowledging that it received

1 their case for consideration. (App. Ltr., Exhibit 2.) Appellants also state that tax year 2006 had also
2 been accepted for audit reconsideration and attached a letter from the IRS, dated June 30, 2010,
3 indicating that their inquiry of April 2, 2010, was being forwarded to its Memphis Service Center for
4 processing.

5 Appellants contend in their appeal letter that because federal and California tax
6 provisions are substantially similar, respondent followed the federal actions and, in an oversight,
7 arbitrarily imposed corresponding assessments of additional tax for tax years 2004-2006 without taking
8 into consideration pending audit reconsiderations before the IRS. Appellants request that respondent
9 adjust the assessments in its NPA's for 2004-2006 to reflect supplemental data, memoranda, and revised
10 computations that they will submit. Appellants also request forbearance by respondent until the IRS has
11 made a final decision on their pending federal appeals. Finally, appellants request abatement of interest
12 on any revised tax deficiencies for 2004-2006 and abatement of the accuracy-related penalty imposed
13 against them for 2006.

14 Respondent's Opening Brief

15 Respondent contends in its opening brief that appellants have not met their burden of
16 proving that respondent's assessments of additional tax based on federal audit reports are incorrect.
17 Respondent states that a review of recently received federal account transcripts, dated November 3,
18 2010, for all three of the tax years under consideration does not show any additional abatement of
19 federal tax or any indication that there are currently any claims pending by appellants. Respondent also
20 states that the federal account transcript for each appeal year shows that not only did appellants agree to
21 the federal assessment but also they signed an agreement with the IRS. Finally, respondent urges
22 appellants to provide any documentation supporting their position so that respondent and the Board may
23 review it in connection with this appeal.

24 Respondent also contends that appellants have not shown that it improperly imposed an
25 accuracy-related penalty against them for 2006. Respondent states that appellants' federal transcript for
26 2006 indicates that the IRS imposed an accuracy-related penalty against them for that year. Citing the
27 *Appeal of Robert and Bonnie Abney* (82-SBE-104), decided by the Board on June 29, 1982, respondent
28 argues that its assessment of a penalty is presumptively correct when based upon a corresponding

1 federal action. In that regard, respondent states that, under Internal Revenue Code (IRC) section
2 6664(c), an accuracy-related penalty may be abated under certain conditions upon a showing of
3 reasonable cause and good faith. Respondent also states that “[i]n addition to reasonable cause, the
4 defenses to an accuracy-related penalty based upon a substantial understatement are (1) substantial
5 authority or (2) adequate disclosure and reasonable basis.” (Resp. Br., p. 5.) Respondent asserts that
6 appellants have not made arguments or submitted any evidence to establish any of the defenses to the
7 accuracy-related penalty.

8 With regard to the interest at issue, respondent states that respondent has the authority to
9 abate interest under R&TC section 19104 if the taxpayer meets all of the requirements to allow such an
10 abatement. Respondent asserts that “there must be unreasonable error or delay in the performance of a
11 ministerial or managerial act occurring after the first contact.” (Resp. Br., p. 6.) Respondent contends
12 that the interest at issue should not be abated because appellants have not alleged or shown such an error
13 or delay.

14 Appellants’ Reply Brief

15 In their reply brief, appellants allege that appellants were victimized by the failure of an
16 IRS auditor to consider adequately evidence presented to him that a flood had partially destroyed their
17 audit records. Appellants state that the auditor refused to permit them to submit secondary proof of the
18 claimed deductions. Appellants argue, as they essentially did at protest, that their former representative
19 also victimized them by inducing them to agree to large assessments by the IRS on the false assumption
20 that they were appropriate candidates for an Offer-in-Compromise. In addition, appellants allege that
21 the former representative “did not counsel appellant wife (who was not a party to her husband’s separate
22 chiropractic business) to challenge the civil fraud penalty(ies) assessed against the couple based upon
23 the alleged overstatements of ordinary and necessary expenses on Schedule C of appellant husband’s
24 separate business. A serious challenge has been presented on the issue of the civil fraud penalty(ies) to
25 set penalty(ies) aside.” (App. Br., p. 2.)

26 Appellants state again that a formal request has been made for federal audit
27 reconsideration for tax years 2004-2006 and that supporting documentation accompanied the request.
28 They state that, after the request was granted, the case was transferred to an IRS Appeals Officer for an

1 independent hearing. Appellants assert that a hearing is “projected to be scheduled in the near future.”
2 (App. Br., p. 2.)

3 Appellants allege that they will establish that the additions to income as reported on the
4 RAR’s, and on which respondent relied, are in error and that they are entitled to the disallowed
5 deductions. Appellants state they will present documentation supporting their claims so that respondent
6 and the Board may review it in connection with this appeal. They state that the documentation will be
7 mailed under separate cover, by priority certified mail, to the Board and respondent’s representative.
8 (App. Br., p. 3.)

9 With regard to the interest at issue, appellants argue that they meet all of the requirements
10 for an abatement of that interest. They state that there has been “unreasonable delay by the Internal
11 Revenue Service in getting this Appeal granted and arranging a timely hearing on the merit(s) since the
12 first contact. The taxpayers cannot be faulted on this delay (they have struggled to have their day in
13 Court!!!).” (App. Br., p. 3.) Appellants indicate that, at the hearing in this matter, they will
14 “demonstrate the erroneous tax liabilities and civil fraud penalties that have been assessed against their
15 account based upon the documentation forwarded under separate cover.” (App. Br., p. 3.)

16 Respondent’s Reply Brief

17 In its reply brief, respondent states that the documentation to which appellants referred in
18 their brief has been provided to respondent. It also states that the documentation included: (1) copies of
19 amended federal returns and originally filed federal returns for each appeal year, (2) a statement
20 contending that appellant-wife should not be made liable for reporting errors in appellant-husband
21 chiropractic business, and (3) a copy of an alleged travel expense report apparently prepared by
22 appellant-husband at the request of the IRS. Respondent asserts that it reviewed the documents
23 submitted by appellants for each of the appeal years and concluded that appellants have not established
24 entitlement to any of the claimed deductions disallowed by the IRS.¹

25 For 2004, respondent states that, upon review of appellants’ amended 2004 federal return
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27 ¹ Although appellants indicated in their brief that they would mail documentation to the Board as well as to respondent’s
28 representative, the Board has not yet received the documentation that respondent’s representative has apparently received and reviewed.

1 and explanations, it noted 12 items, which it discusses in the brief. (Resp. Reply Br., pp. 2-3.) For
2 example, respondent noted that “[e]xpenses claimed for office supplies were not verified for the IRS and
3 the representative states that these supplies were paid for in cash, but the records of these purchases were
4 destroyed by a flood.” (Resp. Reply Br., p. 2, no. 7.) For 2005, respondent indicates that although
5 appellants’ amended 2005 federal return stated that full documentation was attached to the amended
6 return to refute the RAR adjustments and the fraud penalty, there was no documentation attached to the
7 amended return. For 2006, respondent states that, upon review of appellants’ amended 2006 federal
8 return and explanations, it noted three items, which it discusses in the brief. (Resp. Reply Br., pp. 3-4.)
9 For example, respondent noted that “[n]o explanation or reason is submitted with regard to the 2006
10 Schedule C adjustments. Documents submitted by the representative include office expense items, but
11 there is no explanation for such things as a \$1,495 bill from a BMW dealership included in the Office
12 Repairs journal.” (Resp. Reply Br., p. 3, no. 1.)

13 Respondent also states that the alleged travel expense report prepared by appellant-
14 husband offers explanations for travel expenses claimed by appellants. According to respondent, the
15 report indicates that appellants went to Vail, Colorado to tour a chiropractic clinic. Respondent states
16 that the report also indicates that appellants went to Hawaii so that appellant-wife could “‘look at a Time
17 Share Investment’ and ‘learn how to sell real estate and get into the time share business.’” (Resp. Reply
18 Br., p. 4.)

19 With regard to the interest at issue, respondent argues that appellants’ reliance on alleged
20 unreasonable delay by the IRS is misplaced. Respondent states that, under R&TC section 19104,
21 subdivision (a)(3), respondent may abate interest for the same period for which the IRS abates interest
22 under IRC section 6404(e) because of an unreasonable error or delay by an employee of the IRS.
23 Respondent argues that appellants have not shown the IRS has abated interest under IRC section 6404(e)
24 for any of the appeal years. In that regard, respondent states that the federal account transcripts for the
25 appeal years show that interest was charged on the various federal assessments but that there is no
26 indication any of the interest has been abated.

27 In the conclusion of its reply brief, respondent asserts that, on the basis of its review of
28 the items provided by appellants, they have not shown the federal determinations to be erroneous.

1 Respondent argues that the items reported by appellants are obviously inconsistent with the operation of
2 a chiropractic firm. Respondent also argues that appellant-wife's new real estate business, allegedly first
3 reported on a Schedule C-EZ in 2006, does not justify travel to Hawaii to learn about the business of
4 selling time shares because she could have obtained that background near her home in Southern
5 California. In addition, respondent alleges that although appellants have referred to a flood in their
6 home, they have not provided documentation regarding a flood or other information establishing a
7 casualty loss. Respondent states that appellants have provided no evidence regarding the manner in
8 which records were stored or why some, but not all, alleged business records were lost. Finally,
9 respondent asserts that, under R&TC section 19104, it is not an abuse of its discretion to refuse to abate
10 the interest on the additional tax it assessed because the interest is not attributable to an unreasonable
11 error or delay by an employee of the IRS or respondent in the performance of a ministerial or managerial
12 act after first written contact.

13 Applicable Law

14 It is well settled that respondent's determination based on a federal audit report is
15 presumptively correct and that the burden is on the taxpayer to prove that the determination is erroneous.
16 (*Appeal of Sheldon I. and Helen E. Brockett*, 86-SBE-109, Jun. 18, 1986.) A taxpayer's unsupported
17 assertions are not sufficient to satisfy that burden. (*Appeal of Aaron and Eloise Magidow*, 82-SBE-274,
18 Nov. 17, 1982.) The presumption of correctness that attaches to respondent's determinations based on a
19 federal audit report applies as well with respect to an accuracy-related penalty. (*See Appeal of Robert*
20 *and Bonnie Abney, supra.*)

21 It is also well settled that the taxpayer bears the burden of establishing his entitlement to a
22 claimed deduction. (*Appeal of Robert R. Telles*, 86-SBE-061, Mar. 4, 1986.) The Board has stated that,
23 in order to carry his burden, he must point to an applicable statute and show by credible evidence that he
24 comes within its terms. (*Appeal of Robert R. Telles, supra.*) Finally, the Board has stated that
25 unsubstantiated assertions by the taxpayer are not sufficient to satisfy his burden of proof. (*Appeal of*
26 *Robert R. Telles, supra.*)

27 R&TC section 19104, subdivision (a)(1), provides that respondent may abate all or any
28 part of interest on a deficiency, or related to a proposed deficiency, to the extent that interest is

1 attributable in whole or in part to any unreasonable error or delay by an officer or employee of
2 respondent (acting in his or her official capacity) in performing a ministerial or managerial act. R&TC
3 section 19104, subdivision (a)(3), provides, in pertinent part, that respondent may abate all or any part of
4 interest accruing from a deficiency based on a final federal determination of tax, for the same period that
5 interest was abated on the related federal deficiency amount under IRC section 6404(e), and the error or
6 delay occurred on or before the issuance of the final determination. R&TC section 19104, subdivision
7 (b)(1), provides generally that, for purposes of subdivision (a) of that section, an error or delay shall be
8 taken into account only if no significant part of that error or delay can be attributed to the taxpayer
9 involved and after respondent has contacted the taxpayer in writing with respect to that deficiency.

10 IRC section 6404(e)(1)(A) provides that the IRS may abate the assessment of all or any
11 part of interest on any deficiency attributable in whole or in part to any unreasonable delay by an officer
12 or employee of the IRS (acting in his official capacity) in performing a ministerial or managerial act.
13 That section further provides that, for purposes of the foregoing sentence, an error or delay shall be
14 taken into account only if no significant part of such error or delay can be attributed to the taxpayer
15 involved and after the IRS has contacted the taxpayer in writing with respect to such deficiency.

16 Treasury Regulation section 301.6404(b)(1) defines a “managerial act” as an
17 administrative act that occurs during the processing of a taxpayer’s case and that involves the temporary
18 or permanent loss of records or the exercise of judgment or discretion with regard to the management of
19 personnel. That section further provides that a general administrative decision, such as the decision on
20 how to organize the processing of tax returns or a delay in implementing an improved computer system,
21 is not a managerial act. Treasury Regulation section 301.6404(b)(2) defines a “ministerial act” as a
22 procedural or mechanical act that does not involve the exercise or judgment or discretion and that occurs
23 during the processing of a taxpayer’s case after all prerequisites to the act, such conferences and review
24 by supervisors, have taken place.

25 R&TC section 19164, subdivision (a)(1)(A), provides that an accuracy-related penalty
26 shall be imposed under that part and shall be determined in accordance with IRC section 6662, except
27 as otherwise provided. IRC section 6662(a) provides that if that section applies to any portion of an
28 underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to

1 20 percent of the portion of the underpayment to which it applies. IRC section 6662(b) provides, in
2 pertinent part, that the section will apply to any portion of the underpayment that is attributable to (1)
3 negligence or disregard of rules or regulation or (2) any substantial understatement of income tax. IRC
4 section 6662(c) provides that, for purposes of the section, “negligence” includes any failure to make a
5 reasonable attempt to comply with the provisions of the IRC. IRC section 6662(d)(1)(A) provides that,
6 in general, there is a “substantial understatement” of income tax for any taxable year if the amount of the
7 understatement for the taxable year exceeds the greater of (i) 10 percent of the tax required to be shown
8 on the return for the taxable year or (ii) \$5,000. IRC section 6662(d)(1)(B) provides, in pertinent part,
9 that, in the case of a corporation other than an S corporation or a personal holding company, there is a
10 substantial understatement of income tax for any taxable year if the amount of the understatement for the
11 taxable year exceeds the lesser of (i) 10 percent of the tax required to be shown on the return for the
12 taxable year (or, if greater, \$10,000) or (ii) \$10,000,000. R&TC section 19164, subdivision (a)(3),
13 modifies IRC section 6662(d)(1)(B) by substituting “\$2,500” for “\$10,000” and by substituting
14 “\$5,000,000” for “\$10,000,000.”

15 IRC section 6662(d)(2) provides, in pertinent part, that the term “understatement” means
16 the excess of (i) the amount of tax required to be shown on the return for the taxable year over (ii) the
17 amount of tax imposed which is shown on the return. IRC section 6662(d)(2)(B)(i) provides that the
18 amount of the understatement of tax is reduced by the portion of the understatement that is attributable
19 to the tax treatment of any item by the taxpayer if there is or was “substantial authority” for such
20 treatment. IRC section 6662(d)(2)(B)(ii) provides, in pertinent part, that the amount of the
21 understatement of tax is also reduced by the portion of the understatement that is attributable to any item
22 if (I) the relevant facts affecting the item’s tax treatment are adequately disclosed in the return or in a
23 statement attached to the return and (II) there is a “reasonable basis” for the tax treatment of such item
24 by the taxpayer. IRC section 6664(c)(1) provides, in pertinent part, that no penalty shall be imposed
25 under section 6662 on any portion of an underpayment if it is shown that there was a reasonable cause
26 for such portion and that the taxpayer acted in good faith with regard to that portion.

27 STAFF COMMENTS

28 Appellants should be prepared at the hearing to provide legal argument why respondent’s

1 determinations based on federal audit reports are incorrect. Appellants should also be prepared to offer
2 legal argument why the interest at issue and the accuracy-related penalty imposed against appellants for
3 2006 should be abated if respondent's other determinations are upheld. In support of their legal
4 arguments, appellants should provide 14 days or more before the hearing (1) the documentation that it
5 has already provided to respondent's representative but not as yet to the Board, (2) documentation
6 showing that the IRS has revised its determinations for any of the appeal years in a manner favorable to
7 appellants, and (3) any other relevant documentation that it wishes to present. Documentation should be
8 sent, with a copy to respondent, to the following:

9 **Claudia Madrigal, Appeals Analyst**
10 **Board Proceedings Division**
11 **State Board of Equalization**
12 **P.O. Box 942879, MIC: 80**
13 **Sacramento, CA 94279-0080**

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