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BOARD OF EQUALIZATION
STATE OF CALIFORNIA

In the Matter of the Appeal of:) **HEARING SUMMARY¹**
) **PERSONAL INCOME TAX APPEAL**
) **JOHN HAROLD KRAFT**) Case No. 446023

<u>Years</u>	<u>Proposed Assessments</u>
2003	\$7,634.40 ²
2004	\$7,024.80 ³

Representing the Parties:

For Appellant: John Harold Kraft
For Franchise Tax Board: L. Red Gobuty, Tax Counsel

¹ Respondent requested a pre-hearing conference prior to oral hearing to provide appellant with an opportunity to present information that appellant stated in his reply brief would substantiate his claimed business expense deductions. A conference was originally scheduled in April 2009 but subsequently cancelled when appellant agreed to submit the documentation necessary to prove the claimed business expense item deductions which respondent disallowed. However, after reviewing the documentation submitted, respondent affirmed its determination that the deductions were properly disallowed.

This appeal was originally scheduled for hearing at the February 2010 Board meeting but was postponed at the request of appellant.

² This is the amount stated in the Notice of Action (NOA) dated March 12, 2008, which consists of \$6,362.00 in additional tax and an accuracy-related penalty of \$1,272.40, plus applicable interest.

³ This is the amount stated in the NOA dated March 12, 2008, which consists of \$5,854.00 in additional tax and an accuracy-related penalty of \$1,170.80, plus applicable interest.

- 1 QUESTIONS: (1) Whether appellant has shown that the federal adjustments, upon which the
2 proposed deficiency assessments are based, are erroneous.
- 3 (2) Whether appellant has established reasonable cause for abatement of the
4 accuracy-related penalties.

5 HEARING SUMMARY

6 Background

7 For both of the years at issue, appellant filed timely California income tax returns (Form
8 540). For taxable year 2003, appellant reported wages of \$92,974 and on the attached Schedule CA
9 (540), appellant reported business losses of (\$81,915) identified as Schedule C Profit or Loss from
10 Business on the federal Form 1040. Additionally, appellant reported California adjusted gross income
11 (AGI) of \$11,059 and taxable income of \$3,575. He reported tax of \$36, claimed exemption credits of
12 \$82, withholding credits of \$6,172, and reported an overpayment of \$6,172. Respondent subsequently
13 refunded appellant the claimed overpayment of \$6,172. (Resp. Opening Br., pp 1-2.)

14 For taxable year 2004, appellant reported wages of \$89,525 and on the attached Schedule
15 CA (540), appellant reported business losses of (\$60,247) identified as Schedule C Profit or Loss from
16 Business on the federal Form 1040. Additionally, appellant reported California AGI of \$29,278 and
17 taxable income of \$13,349. He reported tax of \$205, claimed exemption credits of \$85, withholding
18 credits of \$5,696 and reported an overpayment of \$5,576. Respondent subsequently refunded appellant
19 the claimed overpayment of \$5,576. (Resp. Opening Br., p. 2.)

20 On December 13, 2006, respondent received a report of appellant's Income Tax
21 Examination Changes (RAR) for taxable years 2003 and 2004 from the Internal Revenue Service (IRS).
22 The 2003 RAR indicated that the IRS proposed an adjustment to increase federal income by \$91,333
23 and federal tax by \$18,595, and to impose an accuracy-related penalty under Internal Revenue Code
24 (IRC) section 6662 in the amount of \$3,719. Appellant did not report these adjustments to respondent.
25 Based on the RAR, respondent issued a Notice of Proposed Assessment (NPA) on October 5, 2007, in
26 which respondent disallowed Schedule C expenses in the amount of \$81,915 and California itemized
27 deductions totaling \$7,484, but allowed a standard deduction of \$3,070. As a result of these
28 adjustments, appellant's taxable income increased by \$86,329.00 to \$89,904.00, the NPA proposed

1 additional tax of \$6,362.00, and imposed an accuracy-related penalty of \$1,272.40, as well as an
2 estimate of accrued interest. (Resp. Opening Br., pp. 2-3.)

3 The 2004 RAR indicated that the IRS proposed an adjustment to increase federal income
4 by \$75,935.00 and federal tax by \$16,936.00, and to impose an accuracy-related penalty under IRC
5 section 6662 in the amount of \$3,387.20. Appellant did not report these adjustments to respondent.
6 Based on the RAR, respondent issued a NPA on October 5, 2007, which disallowed Schedule C
7 expenses in the amount of \$60,247 and disallowed reported California itemized deductions in the
8 amount \$15,929, but allowed a standard deduction in the amount of \$3,165. As a result, appellant's
9 taxable income increased by \$73,011.00 to \$86,360.00, and the NPA proposed additional tax of
10 \$5,854.00, imposed an accuracy-related penalty of \$1,170.80, and added an estimate of accrued interest.
11 (Resp. Opening Br., pp. 2-3.)

12 Appellant timely protested the NPAs and asserted that he could not timely provide the
13 IRS documentation of the expenses for which he claimed deductions because his business was focusing
14 on winning a software contract. Appellant's protest also stated that he entered into an agreement with
15 the IRS whereby he elected to capitalize the expenses at the time of completing the software contract
16 rather than producing records to support the deductions. Appellant noted that his business uses cash
17 basis accounting and he provided schedules and statements to attempt to substantiate his expenses and
18 establish entitlement to the disallowed deductions. Respondent affirmed the NPAs with Notices of
19 Action (NOAs) dated March 12, 2008. Appellant filed this timely appeal. (Resp. Opening Br., pp. 3-4.)
20 QUESTION (1): Whether appellant has shown that the federal adjustments, upon which the proposed
21 deficiency assessments are based, are erroneous.

22 Contentions

23 Appellant's Contentions

24 Appellant states that the documents attached to his appeal letters are the "Detailed
25 Business Expense Items (Schedule C)" for tax years 2003 and 2004 which provide listings of his 2003
26 and 2004 expense items. Appellant contends that the expenses shown are "more than necessary to
27 eliminate any assessment, and even allow for an excess to be carried over to future tax periods."
28 Appellant further states that he is now able to provide expense detail to the IRS for both tax years.

1 Appellant explains that the expense detail documentation was not available during the IRS audit so he
2 elected to capitalize the expenses rather than deducting them. (Appeal Letter, p. 1.) In response to a
3 request from Board staff, appellant provided documentation consisting of schedules, credit card
4 statements, bank statements and check registers to support the claimed Schedule C expense deductions.
5 (App. Supp. Info.)

6 Respondent's Contentions

7 Respondent contends that appellant has failed to meet his burden of proving error in the
8 proposed assessments, which are based on the federal determinations. Respondent asserts that its
9 examination of the federal audit reports and individual master file (IMF) transcripts for tax years 2003
10 and 2004 shows that the adjustments set forth in the RARs have not been revised. In addition,
11 respondent asserts that a comparison of the federal audit reports with the NPAs shows the proposed
12 additional assessments followed the federal adjustments. Respondent contends that a deficiency
13 assessment based on a federal audit report is presumptively correct and appellant bears the burden of
14 proving error. Respondent contends that appellant has not presented credible evidence to meet his
15 burden of proof. (Resp. Opening Br., pp 4-5.)

16 With respect to appellant's statement that he capitalized the Schedule C expenses related
17 to his software business for federal income tax purposes, respondent contends this Board has
18 consistently held that where federal and state law are the same, a federal determination that expenses
19 must be capitalized is binding for California income tax purposes. In addition, respondent asserts that
20 appellant may not deduct those items as current expenses on his California returns because appellant
21 will be allowed future deductions for those assets capitalized for federal tax purposes. If appellant were
22 also allowed future deductions for California tax purposes, then effectively there would be a double
23 deduction for each of those assets. Respondent explains that a taxpayer's federal AGI is used to
24 calculate California taxable income so the same capitalized asset would have an effect on future years of
25 appellant's California income tax liability. (Resp. Opening Br., pp. 5-6.)

26 Respondent also notes (in its Opening Brief) that certain itemized expenses on the federal
27 Schedule A were disallowed and appellant's submitted expense records do not support those itemized
28 deductions. Respondent asserts in its Supplemental Brief that appellant has made no arguments with

1 respect to the itemized deductions, and they accordingly appear to be undisputed.

2 Respondent states that accuracy-related penalties under Revenue and Taxation Code (R&TC)
3 section 19164 were imposed based on federal accuracy-related penalties imposed by the IRS.

4 Respondent asserts that appellant's understated tax for each year clearly exceeds the threshold amount of
5 tax required to be shown on the return so as to trigger the penalty. Respondent contends that appellant's
6 statement that he had to devote time to winning a software contract rather than providing records and
7 information to support the claimed deductions does not constitute reasonable cause for abatement of the
8 penalties. (Resp. Opening Br., p. 6.)

9 In a supplemental brief, respondent discusses its review of the additional information
10 submitted by appellant in response to Board staff's request. Respondent indicates appellant's position is
11 that he provided sufficient detail to substantiate certain Schedule C business expenses so respondent's
12 additional assessments and penalties should be withdrawn. Respondent concludes that the information
13 submitted by appellant does not substantiate any of the items claimed as business expenses. Thus,
14 respondent contends that appellant failed to rebut the presumption it properly disallowed these
15 deductions. (Resp. Supp. Br., pp. 1-3.)

16 Respondent argues that there is no indication the IRS allowed appellant to capitalize the
17 expenses as appellant asserts in its briefing. Furthermore, respondent contends that appellant has not
18 provided any description of the business activities undertaken or provided any documentation to suggest
19 he was carrying on a consulting or software development business during either taxable year.

20 Respondent adds that appellant appeared to hold a full-time job as an employee of Kaiser Foundation
21 Hospitals so appellant would probably have devoted limited time to another business. (Resp. Supp. Br.,
22 p.4.) Finally, respondent contends that appellant would be entitled to capitalize the expenditures made
23 in 2003 and 2004 taxable years only if he substantiated they were start-up expenses paid or incurred in
24 connection with the investigation, acquisition or creation of an active trade or business. (Resp. Supp.
25 Br., p.28.)

26 Respondent contends that appellant has the burden of proving he operated a functioning
27 consulting/software business in 2003 and 2004 for purposes of claiming the Schedule C business
28 expense deductions. In this regard, respondent notes that the U.S. Tax Court identified the following

1 three elements as typically indicative of the existence of a trade or business:

- 2 • (1) The taxpayer must undertake an activity intending to make a profit.
- 3 • (2) The taxpayer must be regularly and actively involved, and
- 4 • (3) The taxpayer must actually have commenced business operations.

5 (Resp. Supp. Br., p.5.)

6 Respondent asserts that the third element is an issue of fact for which the test is whether
7 the business began to function as a going concern and whether the business performed those activities
8 for which it was organized. With respect to appellant's statements as to his reason for failing to provide
9 records to the IRS and his election to capitalize those expenses, respondent states that a taxpayer is
10 allowed to capitalize start-up expenses and, therefore, asserts that appellant's statement indicates he was
11 not carrying on a software development or consultation business in tax years 2003 and 2004.

12 Respondent questions appellant's representation that he held several business licenses and appellant's
13 statement that "California Software Services . . . functions to supply computer support." Respondent
14 states that "appellant's precise business activities during the taxable years at issue are unclear as is the
15 nature and purpose of California Software Services." With respect to the business licenses, respondent
16 asserts that there is no evidence appellant was conducting or carrying on any of these businesses during
17 the tax years in issue. Respondent notes that appellant did not obtain a real estate broker's license until
18 2005 and did not obtain a real estate appraiser's license until 2007. (Resp. Supp. Br., pp. 5-6.)

19 With respect to the profit-making element, respondent states that such a determination is
20 made by reference to objective standards in which the facts and circumstances must indicate the
21 taxpayer entered into or continued the activity with the goal of making a profit. Respondent contends
22 that more weight is given to objective facts than to the taxpayer's statement of intent. In the application
23 of this test, respondent repeats the contention that appellant has not provided any description of the
24 business activities undertaken during the years at issue or provided documentation to suggest that he was
25 carrying on a software business. Respondent concludes that appellant may not have been engaged in
26 such activities for profit considering that appellant reported no income or gross receipts for several
27 years. If appellant was not engaged in business activities for profit in view of the fact that appellant
28 reported no gross receipts, respondent contends any deductions related to these activities would be zero.

1 (Resp. Supp. Br., pp. 6-7.)

2 Finally, respondent contends, even assuming arguendo that appellant substantiated he
3 was conducting a business for profit for the years at issue, appellant must still show the claimed
4 deductions were for ordinary and necessary expenses incurred during the taxable year in carrying on his
5 business. Respondent contends that the schedules and bank and credit card statements submitted by
6 appellant do not establish whether the expenditures were ordinary and necessary business expenses nor
7 do they indicate whether the payments were for personal or other non-deductible expenditures. Thus,
8 respondent contends that appellant has not met his burden of proof to demonstrate entitlement to
9 business deductions for an ongoing business. (Resp. Supp. Br., pp. 7-8.)

10 Respondent discusses in greater detail its conclusions concerning appellant's claimed
11 Schedule C expenses by category and by tax year based on its examination of the bank and credit card
12 statements as follows:

13 Tax Year 2003

- 14 • Advertisement Expenses: Respondent's examination showed that, with the exception of one item
15 in the amount of \$50, the statements agreed with the individual "advertisement" transactions
16 listed on appellant's schedule. However, respondent contends that appellant has not provided
17 any documentation such as purchase orders, invoices or receipts identifying the purchases and
18 thus establishing that any of those purchases were ordinary and necessary expenses for the
19 alleged computer software business.
- 20 • Car and Truck Expenses: Respondent's examination showed the statements agreed with the
21 individual "car and truck" transactions listed. However, respondent contends that appellant has
22 not provided any evidence to establish any of those purchases were ordinary and necessary
23 expenses for the computer software business. As an example, respondent states that appellant
24 reported payments of \$3,146 to a credit card issuer but failed to provide information to determine
25 whether appellant is the credit card holder/obligor on the account, the nature of the purchases and
26 whether the payments related to deductible car and truck expenses. Respondent contends that
27 appellant has not provided documentation to show the portion of his expenditures relating to
28 business use rather than personal use. Finally, respondent asserts that the IRC and Treasury

1 Regulations require that a taxpayer substantiate a claimed deduction or credit by sufficient
2 evidence and adequate records of specified types. Respondent contends that appellant has not
3 provided any documentation, such as a mileage log, to substantiate his business use of the
4 vehicle, whether the payments were for the lease or purchase of the vehicle and, if purchased, the
5 price paid.

- 6 • Depreciation and IRC section 179 Expenses: Respondent’s examination showed that, with
7 several exceptions, the statements agreed with the individual “depreciation and 179” transactions
8 listed on appellant’s schedule. In addition, respondent asserts that many of the payments appear
9 to be made to a credit card but there is insufficient evidence to determine whether appellant is the
10 credit card holder/obligor on the account, the nature of the purchases and whether the payments
11 related to capital expenditures of appellant’s Schedule C business. Finally, respondent contends
12 that appellant has not provided any documentation such as purchase orders, invoices or receipts
13 identifying the purchases and thus establishing that any of those purchases were ordinary and
14 necessary expenses for the alleged computer software business.
- 15 • Insurance Expense: Respondent’s examination showed the statements agreed with the individual
16 “insurance” transactions listed. Respondent contends that appellant has not provided any
17 documentation to establish the purchases were ordinary and necessary expenses for the alleged
18 computer software business, nor has he identified what was purchased. In addition, respondent
19 contends that any payment related to vehicle insurance must meet the substantiation
20 requirements of IRC section 274.
- 21 • Legal and Professional Expenses: Respondent’s examination showed the statements agreed with
22 the individual “legal and professional” transactions listed. Respondent contends that appellant
23 has not provided any documentation to establish the purchases were ordinary and necessary
24 expenses for the alleged computer software business, nor has he identified what was purchased.
25 Respondent also states that several of the payments, such as the Sierra Club and Multistate Legal
26 Study, appear to be personal in nature or unrelated to the alleged computer software/consulting
27 business. Finally, respondent asserts that it could not make a determination as to whether these
28 expenditures are deductible business expenses because appellant failed to provide sufficient

1 documentation.

- 2 • Office Expense: Respondent’s examination showed the statements agreed with the individual
3 “office expense” transactions listed. Among the expenses are payments to appellant described as
4 “office supply” but respondent may not allow deductions for such payments by appellant to
5 himself. In addition, there are payments to Maria Escalante (described as “rent”) with whom
6 appellant had a close personal relationship in 2003. Thus, it appears that the payments to Ms.
7 Escalante may relate to personal or living expenses rather than deductible expenses of a Schedule
8 C business.
- 9 • Auto – Rent Expense: Respondent examined the statements and was unable to verify the \$1,300
10 in “rental or lease” transactions listed on any of the statements. In addition, respondent states
11 that the payments were made to an American Express credit card but there is insufficient
12 evidence to determine whether appellant is the credit card holder/obligor on the account, the
13 nature of the purchases and whether the payments related to capital expenditures of appellant’s
14 Schedule C business.
- 15 • Repair and Maintenance Expense: Respondent’s examination showed the statements agreed
16 with a majority of the “repairs & maintenance” transactions listed. Among those transactions
17 were two purchases made in 2002, which should be expensed in that year and not 2003.
18 Respondent contends that appellant has not provided any documentation to establish the
19 purchases were ordinary and necessary expenses for the alleged computer software business, nor
20 has he identified what was purchased. In addition, respondent asserts that the majority of the
21 payments were made to a credit card but there is insufficient evidence to determine whether
22 appellant is the credit card holder/obligor on the account, the nature of the purchases and whether
23 the payments related to capital expenditures of appellant’s Schedule C business.
- 24 • Supplies Expense: Respondent’s examination showed the statements agreed with a majority of
25 the “supplies” transactions listed. Among those transactions were two purchases made in 2002,
26 which should be expensed in that year and not 2003. Respondent contends that appellant has not
27 provided any documentation to establish the purchases were ordinary and necessary expenses for
28 the alleged computer software business, nor has he identified what was purchased. Respondent

1 asserts that purchases from Costco, Eddie Bauer, Robinson May, Macy's, Smart & Final and
2 Target appear to be personal items based on the nature of merchandise carried by these stores. In
3 addition, other payments are not identified and appear to be personal items. Finally, payments to
4 Office Depot and Staples may be business-related, but without receipts, respondent cannot verify
5 these were deductible business expenses.

- 6 • Taxes and License Expense: Respondent's examination showed the statements agreed with the
7 majority of the "tax and license" transactions listed. Respondent contends that appellant has not
8 provided any documentation to establish the purchases were ordinary and necessary expenses for
9 the alleged computer software business, nor has he identified what was purchased. Respondent
10 further contends that fees paid to the California Secretary of State (SOS) are not necessarily
11 related to any identifiable business purpose and payments related to personal vehicles do not
12 meet the substantiation requirements of IRC section 274.
- 13 • Air and Hotel Expense: Respondent's examination showed the statements agreed with the
14 individual "travel" transactions listed. Respondent contends that appellant has not provided any
15 documentation to establish the purchases were ordinary and necessary expenses for the alleged
16 computer software business. Respondent notes that an airline ticket purchase for Ms. Escalante
17 was not likely for a business purpose and appellant has not met the documentation requirements
18 of IRC section 274.
- 19 • Meals and Entertainment Expense: Respondent's examination showed the statements agreed
20 with the individual "meals and entertainment" transactions listed. Among those transactions
21 were three purchases made in 2002, which should be expensed, if at all, in that year and not
22 2003. Respondent notes that appellant has not met the substantiation requirements of IRC
23 section 274.
- 24 • Utilities Expense: Respondent's examination showed the statements agreed with the individual
25 "utilities" transactions listed. Respondent contends that appellant has not provided any
26 documentation to establish the payment for cell phone service was an ordinary and necessary
27 expense for the alleged computer software business. Respondent notes that appellant has not met
28 the substantiation requirements of IRC section 274.

- 1 • Other Expenses: Respondent’s examination showed the statements agreed with a majority of the
2 “other” transactions listed. Among those transactions were two purchases made in 2002, which
3 should be expensed, if at all, in that year and not 2003. Respondent notes that appellant failed to
4 account for a \$25 credit refund in 2003. Respondent contends that appellant has not provided
5 any documentation to establish the purchases were ordinary and necessary expenses for the
6 alleged computer software business, nor were the purchased items identified. In addition,
7 respondent notes that some of the payments appear to be for personal expenses, nondeductible
8 telephone service expenses and expenses related to unspecified education or training. (Resp.
9 Supp. Br., pp. 8 - 18.)

10 Tax Year 2004

- 11 • Advertisement Expense: Respondent’s examination showed the statements agreed with the
12 individual “advertisement” transactions listed on appellant’s schedule. However, respondent
13 contends that appellant has not provided any documentation such as purchase orders, invoices or
14 receipts identifying the purchases and thus establishing any of those purchases were ordinary and
15 necessary expenses for the alleged computer software business.
- 16 • Car and Truck Expense: Respondent’s examination showed the statements, with one exception,
17 agreed with the majority of the individual “car and truck” transactions listed. However,
18 respondent contends appellant has not provided any evidence to establish that any of those
19 purchases were ordinary and necessary expenses for the computer software business, nor has he
20 identified what was purchased. Respondent contends that appellant has not provided
21 documentation to show the portion of his expenditures relating to business use rather than
22 personal use. Finally, respondent asserts that IRC and Treasury Regulations require that a
23 taxpayer substantiate a claimed deduction or credit by sufficient evidence and adequate records
24 of specified types. Respondent contends that appellant has not provided any documentation,
25 such as a mileage log, to substantiate his business use of the vehicle, whether the payments were
26 for the lease or purchase of the vehicle and, if purchased, the price paid.
- 27 • Depreciation and IRC section 179 Expenses: Respondent’s examination showed that, with one
28 exception, the statements agreed with the individual “depreciation and 179” transactions listed

1 on appellant's schedule. Respondent contends that appellant has not provided any
2 documentation such as purchase orders, invoices or receipts identifying the purchases and thus
3 establishing that any of those purchases were ordinary and necessary expenses for the alleged
4 computer software business, nor has he identified what was purchased.

- 5 • Insurance Expense: Respondent's examination showed the statements agreed with the individual
6 "insurance" transactions listed. Respondent asserts appellant has not provided any
7 documentation to establish the purchases were ordinary and necessary expenses for the alleged
8 computer software business, nor has he identified what was purchased. In addition, respondent
9 contends that any payment related to vehicle insurance must meet the substantiation
10 requirements of IRC section 274.
- 11 • Legal and Professional Expense: Respondent's examination showed the statements agreed with
12 most of the individual "legal and professional" transactions listed. Respondent states that several
13 of the payments, such as Alison Davis PTK and Foothill Apartment Association, appear to be
14 personal in nature or unrelated to the alleged computer software/consulting business.
15 Respondent contends that appellant has not provided any documentation to establish the
16 purchases were ordinary and necessary expenses for the alleged computer software business, nor
17 has he identified what was purchased.
- 18 • Rent/Office Expense: Respondent's examination showed the statements agreed with the
19 individual "office expense" transactions listed. Respondent notes that the payments to "Deposit
20 Real Estate" and to Maria Escalante are described as "rent" and the rest of the payments are
21 described as "office". As discussed above, it is reasonable to conclude that the payments to Ms.
22 Escalante with whom appellant had a close personal relationship may relate to personal or living
23 expenses rather than deductible expenses of a Schedule C business. In addition, other payments
24 appear to be nondeductible personal expenses.
- 25 • Repair and Maintenance Expense: Respondent's examination showed the statements agreed
26 with the "repairs & maintenance" transactions listed but that appellant failed to consider credits
27 in the amounts of \$215 and \$20. Respondent contends that appellant has not provided any
28 documentation to establish the purchases were ordinary and necessary expenses for the alleged

1 computer software business, nor has he identified what was purchased. In addition, respondent
2 asserts that it is impossible to determine the nature of a payment to Sam Robles which may be
3 personal or a gift.

- 4 • Supplies Expense: Respondent’s examination showed the statements agreed with a majority of
5 the “supplies” transactions listed. Respondent contends that appellant has not provided any
6 documentation to establish the purchases were ordinary and necessary expenses for the alleged
7 computer software business, nor has he identified what was purchased. Respondent asserts that
8 purchases from Big 5, Costco, Gotham Products, Paula’s Fine Leather, Rare Rose Florist and
9 Target appear to be personal items based on the nature of merchandise carried by these stores. In
10 addition, appellant did not provide sufficient detail about payments to a Discover credit card so
11 respondent cannot verify whether these were deductible business expenses.
- 12 • Tax and Licensing Expense: Respondent’s examination showed the statements agreed with the
13 majority of the “tax and license” transactions listed. Respondent contends that appellant has not
14 provided any documentation to establish the purchases were ordinary and necessary expenses for
15 the alleged computer software business. Respondent further contends that fees paid to the
16 California SOS are not necessarily related to any identifiable business purpose and it appears the
17 same payment was included as an item under Legal and Professional Expense. Appellant also
18 claimed federal income tax payments which are not deductible for California tax purposes.
- 19 • Meals and Entertainment Expense: Respondent’s examination showed the statements agreed
20 with a majority of the individual “meals and entertainment” transactions listed. However, there
21 were four restaurant purchases that respondent was unable to verify. Respondent notes that
22 appellant has not met the substantiation requirements of IRC section 274.
- 23 • Utilities Expense: Respondent’s examination showed the statements agreed with the individual
24 “utilities” transactions listed. Respondent notes that the payments were made to Maria Escalante
25 and given the close personal relationship between her and appellant it is reasonable to assume
26 these payments relate to personal or living expenses.
- 27 • Other Expenses: Respondent’s examination showed the statements agreed with a majority of the
28 “other” transactions listed. Respondent was unable to verify five purchases and notes that

1 appellant failed to consider credit refunds in the total amount of \$601. Respondent contends that
2 appellant has not provided any documentation to establish the purchases were ordinary and
3 necessary expenses for the alleged computer software business, nor were the purchased items
4 identified. Furthermore, respondent notes that some of the payments appear to be for personal
5 expenses, nondeductible telephone service expenses and expenses related to unspecified
6 education or training. Finally, appellant reported bank charges relating to a checking account in
7 the name of “John Kraft dba California Software Services” but has not established that he was
8 actively engaged in any trade or business during the 2004 taxable year and has not provided
9 evidence to show this account was primarily used for business rather than personal purposes.
10 (Resp. Supp. Br., pp. 19 -27.)

11 Respondent concludes that appellant has only provided schedules and bank and credit
12 card statements which do not establish appellant is entitled to the claimed deductions because they do
13 not establish what was purchased, and do not substantiate that expenditures are ordinary and necessary
14 for the purpose of carrying on a trade or business rather than for personal or other non-deductible
15 purposes. (Resp. Supp. Br., p. 27.)

16 Applicable Law

17 Burden of Proof

18 Federal Determination

19 R&TC section 18622 provides that a taxpayer shall either concede the accuracy of a
20 federal determination or state wherein it is erroneous. It is well-settled that a deficiency assessment
21 based on a federal audit report is presumptively correct, and the taxpayer bears the burden of proving
22 that the determination is erroneous. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Sheldon I.*
23 *and Helen E. Brockett*, 86-SBE-109, June 18, 1986.) Unsupported assertions are not sufficient to satisfy
24 appellant’s burden of proof. (*Appeal of Aaron and Eloise Magidow*, 82-SBE-274, Nov. 17, 1982.) In
25 the absence of uncontradicted, credible, competent, and relevant evidence showing error in respondent’s
26 determinations, they must be upheld. (*Appeal of Oscar D. and Agatha E. Seltzer*, 80-SBE-154, Nov. 18,
27 1980.) An appellant’s failure to produce evidence that is within his control gives rise to a presumption
28 that such evidence is unfavorable to his case. (*Appeal of Don A. Cookston*, 83-SBE-048, Jan. 3, 1983.)

1 Business Expense Deductions

2 Deductions from gross income are a matter of legislative grace, and the burden is on the
3 taxpayer to show by competent evidence that he is entitled to any deductions claimed. (*New Colonial*
4 *Ice Co. v. Helvering* (1934) 292 U.S. 435.) In the case of travel and entertainment expenses, this burden
5 of proof may be satisfied by records which establish the business nature of the expenditures; the date,
6 place, and amount of the expenditures; the recipient of the funds expended; and the nature of the product
7 or service received. (*Appeal of Oilwell Materials and Hardware Co., Inc.*, 70-SBE-039, Nov. 6, 1970;
8 *Appeal of Bruce D. and Donna G. Varner*, 78-SBE-067, July 26, 1978.) It is insufficient to show simply
9 that expenditures were made, without showing their direct relation to a business purpose. (*Appeal of*
10 *Bruce D. and Donna G. Varner, supra; Appeal of Harold J. and Jo Ann Gibson*, 76-SBE-090, Oct. 6,
11 1976.)

12 The federal tax court has held that a taxpayer's claimed business expense deductions
13 were properly disallowed where the taxpayer's evidence was insufficient to show the expenses were
14 related to or incurred in connection with the taxpayer's purported business. In *Alemasov v. Comm'r*
15 (2007) T.C. Memo 2007-130, the tax court held that the taxpayers' credit card statements and a
16 spreadsheet that was created after the year at issue failed to meet the adequate records requirement of
17 IRC section 274, subdivision (d) and other IRC provisions for various claimed expenses. As one
18 example, the court noted that taxpayers did not provide any evidence, other than a spreadsheet, to
19 support their claimed deduction for advertising expenses. Furthermore, in denying the taxpayers'
20 claimed office supplies expenses, the court acknowledged that credit card statements showed that the
21 taxpayers made purchases at stores that sold office supplies, but held that there was no evidence, other
22 than the taxpayers' self-serving testimony that these expenses were related to or incurred in connection
23 with her business.

24 STAFF COMMENTS

25 As his basis for establishing the federal determination is erroneous, appellant produced
26 schedules and bank and credit card statements of payments made for expenses for which, appellant
27 claims, he is entitled to business expense deductions from gross income. However, it appears not to be
28 clear from the record that appellant actually engaged in the start-up or ongoing operation of a computer

1 software/consulting business as appellant represented. The only representation made by appellant with
2 respect to this business is that he attempted to obtain a software contract but apparently there is no
3 evidence he was undertaking business activity intending to make a profit, he was regularly and actively
4 involved, and the computer software/consulting business commenced business operations. At the
5 hearing, appellant should be prepared to present evidence, such as business advertising, contracts with
6 third parties, accounting records and any other evidence, to support his representation that he was
7 actively engaged in the start-up or ongoing operation of a computer software/consulting business during
8 tax years 2003 and 2004.

9 If appellant presents sufficient credible evidence to establish that he was engaged in the
10 start-up or ongoing operation of a computer software/consulting business, then he still must establish the
11 expenditures are ordinary and necessary for the purpose of carrying on a trade or business rather than for
12 personal or other non-deductible purposes. To date, it appears that appellant has not provided
13 documentation or detailed explanations demonstrating the individual expenditures were deductible. At
14 the hearing, appellant should be prepared to present substantiating documentation, such as vehicle
15 mileage logs, and to provide detailed explanations to verify the claimed expenses are properly
16 deductible as business expenditures.

17 QUESTION (2): Whether appellant has established reasonable cause for abatement of the accuracy-
18 related penalties.

19 Contentions

20 Appellant has not contested the accuracy-related penalties but, presumably, would take
21 the position that respondent improperly imposed the penalties based on overstated tax liability due to
22 respondent's erroneous disallowance of appellant's claimed business expense deductions.

23 Respondent contends that appellant substantially understated his income tax as specified
24 under IRC section 6662(d). In this regard, respondent states that the understatement of tax for 2003 was
25 \$6,362 and the understatement of tax for 2004 was \$5,854 and both amounts are greater than \$5,000 and
26 exceed 10 percent of the tax required to be shown on the returns for those years. Respondent further
27 contends that its penalty determination is presumptively correct and appellant has not presented any
28 evidence to rebut that presumption. (Resp. Opening Br., pp. 6-7.)

1 Applicable Law

2 R&TC section 19164 provides for the imposition of an “accuracy-related penalty”
3 determined in accordance with Section 6662 of the IRC. Here, the penalty was imposed based on a
4 “substantial understatement” of income tax. (Int.Rev. Code, § 6662, subd. (b).) “Substantial
5 understatement of income tax” means “the amount of the understatement for the taxable year exceeds
6 the greater of (i) 10 percent of the tax required to be shown on the return for the taxable year or (ii)
7 \$5,000. (Int.Rev. Code, § 6662, subd. (d).) When based on a federal determination, respondent’s
8 assessment of the accuracy-related penalty is presumptively correct. (*Appeal of Robert and Bonnie*
9 *Abney*, 82-SBE-104, June 29, 1982.)

10 R&TC section 19164, subdivision (d), provides generally for the incorporation by
11 reference of IRC section 6664. IRC section 6664(c)(1) provides, in pertinent part, that no penalty shall
12 be imposed under section 6662 with respect to any portion of an underpayment if it is shown that there
13 was a reasonable cause for such portion and the taxpayer acted in good faith with respect to such
14 portion. Treasury Regulation 1.6664-4(b)(1) provides in relevant part that:

15 The determination of whether a taxpayer acted with reasonable cause and in good faith is
16 made on a case-by-case basis, taking into account all pertinent facts and circumstances.
17 Generally, the most important factor is the extent of the taxpayer’s effort to assess the
18 taxpayer’s proper tax liability. Circumstances that may indicate reasonable cause and
19 good faith include an honest misunderstanding of fact or law that is reasonable in light of
20 all of the facts and circumstances, including the experience, knowledge, and education of
21 the taxpayer.

22 With respect to an underpayment attributable to reliance by the taxpayer on professional
23 advice, Treasury Regulation 1.6664-4(c)(1)(ii) provides the advice must not be based on unreasonable
24 factual or legal assumptions (including assumptions regarding future events) and must not unreasonably
25 rely on the representations, statements, findings, or agreements of the taxpayer or any other person. T
26 hat provision further states, as an example, the advice must not be based on a representation or
27 assumption that the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate
28 representation or assumption regarding the taxpayer’s purposes for entering into a transaction or for
structuring a transaction in a particular manner.

27 STAFF COMMENTS

28 Here, appellant has only represented that he was unable to provide records and

1 information to the IRS for the purpose of supporting his claimed business expense deductions because
2 he was devoting his time to winning a contract. In his appeal letter and supplemental submission,
3 appellant has made no argument or assertion that the substantial understatements of tax occurred even
4 though he acted with reasonable cause and in good faith. At the hearing, if appellant wishes to contest
5 the penalties, appellant should be prepared to present evidence of all pertinent facts and circumstances
6 that led to the substantial understatements, to demonstrate reasonable cause and good faith as a basis for
7 abatement.

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