

1 Charles E. Potter, Jr.
2 Tax Counsel
3 Board of Equalization, Appeals Division
4 450 N Street, MIC: 85
5 PO Box 942879
6 Sacramento CA 95814
7 Tel: (916) 323-3150
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 **JAMES VAUGHN**¹) Case Nos. 508867 and 487205²

	<u>Years</u>	<u>Proposed</u> <u>Assessments</u>
	2005	\$1,927
	2006	\$1,545

16 Representing the Parties:

17 For Appellant:	James Vaughn
18 For Franchise Tax Board:	Christopher R. Parker, Tax Counsel Suzanne L. Small, Tax Counsel III

20 **QUESTION:** Whether respondent properly disallowed certain business expense and unreimbursed
21 employee expense deductions for 2005 and 2006.

22 **HEARING SUMMARY**

23 Background

24 *For the 2005 Tax Year*

25 In 2007, respondent sent appellant a filing compliance letter requesting a response by

27 ¹ Appellant resides in Vacaville, California in Solano County.

28 ² The 2005 appeal (case number 508867) was originally scheduled for the July 2010 calendar and was postponed in order to allow for consolidation with the 2006 appeal (case number 487205).

Schedule C Business Expenses	2005	2006
Advertising	\$396.95	\$485.58
Car & Truck Expenses	\$5,650.40	\$4,695.74
Insurance		\$99.00
Legal & Professional Services	\$1,425.00	\$1,440.57
Rent or Lease of Vehicles	\$3,324.00	\$4,111.00
Rent or Lease of Property	\$12,073.50	\$12,257.00
Repairs & Maintenance	\$2,524.15	\$5,600.20
Supplies	\$2,507.99	\$2,447.73
Taxes and Licenses	\$233.00	\$233.00
Travel		\$1,075.57
Deductible Meals & Entertainment	\$2,804.67	\$2,601.71
Utilities	\$1,060.60	\$1,957.11
<i>Other Expenses</i>		
Liability Insurance	\$99.00	
PDA, Powerbook, computer Accessories	\$2,952.02	
Business Attire	\$2,003.03	\$1,271.03
Moving		\$42.60
Training		\$1,325.00
Workspace Design		\$568.64
Research		\$104.00
Business event registration		\$157.00
Total	\$37,054.31	\$40,472.48⁴

(2005 Appellant's Appeal Letter (AAL) exhibit C-1; 2006 ROB exhibit A, p. 6.) On the 2005 and 2006 Schedules C, appellant reported zero business gross receipts or sales. (*Id.*) In addition to these business expenses, appellant claimed the following unreimbursed employee business expenses as itemized deductions on his Schedule A for 2005 (appellant's 2006 Schedule A unreimbursed expenses are also included in this table and will be discussed below):

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⁴ This is the amount totaled from the expense items reported on appellant's 2006 Schedule C by Board staff (some numbers were difficult to make out from the copy provided). The total Schedule C business loss deduction reported on line 12 of the 2006 federal return was \$40,466.04, representing a discrepancy of \$6.44, which may be due in part to the quality of the copy provided and does not appear to be material.

Unreimbursed Employee Business Expenses	2005	2006
Mileage	\$744.12	\$766.56
Parking fees, tolls & transportation	\$1,957.50	\$1,957.50
Business expenses	\$14,553.16	\$18,373.51
50 Percent Meals & Entertainment	\$913.50	\$976.00
Total	\$18,168.28 ⁵	\$22,073.57 ⁶

(2005 AAL exhibits B and D; 2006 Appellant's Reply Brief (ARB) dated October 3, 2009, exhibit H.)

On March 6, 2009, respondent requested a copy of appellant's Federal Form 1040 and schedules for 2005. On April 28, 2009, respondent requested this information a second time, since appellant submitted his 2006 tax year forms. On May 30, 2009, appellant submitted his 2005 federal tax information. Although appellant reported zero taxable income on his 2005 California return, on the 2005 Notice of Proposed Assessment (NPA) respondent recalculated appellant's 2005 taxable income as a loss of \$11,817 (rounded).⁷ The 2005 NPA then made the following adjustments:

CA Taxable Income as Revised	(\$11,817.00)
Disallowed Business Expense	\$37,054.00
Disallowed Itemized Deductions	\$18,239.00 ⁸
Revised Taxable Income	\$43,476.00
Tax	\$2,014.00
Personal Exemptions	\$87.00
Tax	\$1,927.00

(A copy of the 2005 NPA was provided as an unnumbered exhibit to the 2005 AAL.) In reviewing the 2005 NPA calculation, it appears to Board staff that if appellant's itemized deductions are disallowed,

⁵ This is the direct total expense amount as shown on the 2005 Form IRS 2106-EZ. For 2005 Schedule A purposes, this amount was reduced by formula for a claimed itemized business expense deduction of \$18,039.82.

⁶ This is the direct total expense amount as shown on the 2006 Form IRS 2106-EZ. For 2006 Schedule A purposes, this amount was reduced by formula for a claimed itemized deduction of \$22,015.25.

⁷ A copy of the 2005 California return was not provided. However, from the 2005 federal returns provided, it appears respondent calculated this revised loss by taking appellant's \$21.13 in interest and \$43,455.82 in wages, and subtracting the Schedule C business loss of \$37,054.31, the Schedule A unreimbursed business deduction of \$18,039.82, and a \$200 claimed charitable deduction. (See 2005 AAL exhibit A-1.)

⁸ This amount represents disallowed unreimbursed business expenses of \$18,039 and a disallowed charitable deduction of \$200.

1 he would be entitled to a standard deduction. Board staff is unsure whether the standard deduction was
2 incorporated into respondent's 2005 tax assessment;⁹ therefore, respondent should review its NPA
3 calculation prior to the oral hearing and inform Board Proceedings whether the tax assessment for 2005
4 allowed for a standard deduction.

5 On July 10, 2009, respondent issued its 2005 NPA showing tax due of \$1,927. On
6 July 27, 2009, respondent issued a 2005 Notice of Action (NOA) that affirmed the 2005 NPA denying
7 appellant's claimed business deductions.

8 *For the 2006 Tax Year*

9 On or about October 15, 2007, respondent received a 2006 tax return from appellant
10 reporting California wages of \$43,382.17, federal adjusted gross income of \$2,916.13, Schedule C
11 business loss of \$40,466.04,¹⁰ itemized unreimbursed employee expenses of \$22,015.25, and zero
12 taxable income. (2006 ROB exhibit A.) Although appellant reported zero taxable income on his 2006
13 California return, respondent recalculated appellant's 2006 income as a loss as follows:

14	Wages	\$43,382.17
15	Schedule C Business Loss	(\$40,466.04)
16	Itemized Business Expense Deduction	(\$22,015.25)
17	Revised Taxable Loss (Rounded)	(\$19,099.00)

18 (2006 ROB footnote 1.)¹¹ Respondent claims when appellant failed to respond to its request for a
19 schedule and documentation for the claimed itemized deductions, it issued its 2006 NPA on June 30,
20 2008, which revised appellant's income and tax for 2006 as follows:

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22 ///

24 ⁹ The standard deduction for the 2006 assessment was included in respondent's 2006 NPA calculation. (See 2006 ROB
25 footnote 2.)

26 ¹⁰ See *supra* footnote 4.

27 ¹¹ Board staff notes respondent's statement in footnote 1 of the 2006 ROB, that the Schedule C business expenses were
28 \$40,468.04, appears to have been in error (perhaps by referencing the NPA, see *infra* footnote 12). However, respondent's
loss calculation in the footnote itself used the correct amount of \$40,466.04 to arrive at a recalculated originally reported loss
of \$19,099.00 as reflected in the table above.

Revised Taxable Loss	(\$19,099.00)
Disallowed Business Loss	\$40,468.04 ¹²
Disallowed Expense Deduction	\$22,015.00
Allowed Standard Deduction	(\$3,410.00)
Revised Taxable Income	\$39,974.04
Tax	\$1,636.00
Personal Exemptions	\$91.00
Additional Tax	\$1,545.00

(2006 ROB at p. 1; 2006 ROB exhibit C.)

Appellant protested the 2006 NPA asserting various reasons why his claimed expenses were related to his massage therapy business and enclosed copies of bank statements and canceled checks in support of his deductions. In discussing these items in his 2006 protest, appellant made the following contentions:

1. “My profession is a dynamic one that covers a very wide spectrum of human experience and service.... I am a therapeutic bodyworker, a wellness consultant, an entertainer, a producer, and aspiring writer. For your purposes here, it may be simplest to understand that virtually every activity in my life relates to my work one way or another. There is virtually no moment in my life –other than sleeping- when I am not engaged in my work somehow.”
2. “For example, something as seemingly unrelated as a parking citation...pays for a service that enables me to conduct my business.”
3. “Similarly, the check for Truckee Sup[e]rior Court was a necessary car expense...[g]etting caught for speeding is really a matter of chance –like an accident.”
4. “My grocery bills[] relate in that I must feed my body healthfully –which must not just function, but function optimally so that I can sustainably conduct the work I do...Another reason I feel grocery bills apply is because I get to deduct my meals when I’m at work for my employer.

¹² It appears to Board staff that the NPA may have incorrectly stated the Schedule C business loss to be \$40,468.04 (rather than \$40,466.04). This would result in \$2 of additional taxable income reported by the 2006 NPA that was not attributable to appellant. Therefore, Board staff reviewed the 2006 single filing tax table and determined that for taxable income amounts from \$39,951 through \$40,050, the tax is \$1,636. (Available online at http://ftb.ca.gov/forms/06_forms/06_540tt.pdf (see page two of the PDF document, last viewed on September 29, 2010.)) Therefore, assuming a \$2 error existed in the disallowed business loss deductions stated in the 2006 NPA, this error would not affect the 2006 tax assessment. If either party takes a different position and believes a materially different outcome would exist, then that party should be prepared to explain their position at the oral hearing.

1 Since I am self-employed –and always working one way or another (except when I’m sleeping),
2 then everything I’m eating is ‘on the job.’ Since Conscious Consuming is another aspect of
3 Holistic Health, part of my own consumption is necessary Research for my consulting service.”

4 5. “Toiletries, haircuts and clothing are also all required for me to do my business. I must look (and
5 smell) agreeable to attract clients.”

6 6. “Movies, books, and shows have multiple purposes related to my business. One is that I must
7 stay informed on both past & current popular culture in order to functionally consult my
8 clients.... Another purpose is for my own wellbeing.”

9 7. “Receiving Therapeutic Bodywork is another necessity for my ability to sustain my work as well
10 as to learn new techniques....Hence this goes under Professional SVCS, Maintenance, and Other
11 Expenses (Further Education & Research)”

12 (2006 Appellant’s Protest Letter, dated January 5, 2009, copy provided in 2006 ROB, exhibit D, p. 1 of
13 65.) Respondent reviewed appellant’s protest and documentation and affirmed the 2006 NPA issuing its
14 2006 NOA on March 30, 2009. This timely appeal of the 2005 and 2006 NOAs followed.

15 Contentions

16 *Appellant’s 2005 Contentions*

17 Appellant contends respondent denied his deductions on the grounds that appellant failed
18 to show profits for his business. (2005 AAL at p. 1.) Appellant claims it is not necessary to show
19 profits for five years before it is considered a hobby loss. (*Id.*) Appellant contends limited time and
20 energy have been factors affecting his profitability, that he had to work 30 plus hours for Kabuki Springs
21 & Spa to earn a living and repay his debts and this left him little time to invest in a private massage
22 practice. (*Id.*)

23 Appellant concedes that he “may have had one or two clients in 2005 at best,” but that he
24 held a reasonable expectation that he could take five clients a week to replace his work at Kabuki. (2005
25 AAL at p. 2.) Appellant also states “it’s hard to make profits with normal personal and business
26 expenses in *San Francisco*.” (*Id.*)

27 Appellant concedes he has no records of any private massage clients for 2005 (*Id.*);
28 however, appellant claims he is not carrying on a private business in massage therapy alone, that he also

1 operates “as a Holistic Health Consultant which covers counseling, nutrition, exercise, and lifestyles of
2 health and sustainability.” (*Id.*) Appellant stated that soon into his career, he “anticipated the
3 limitations in developing a private massage practice” and therefore became “an Independent Associate
4 with the Amazon Herb Company (AHC).” Appellant states that his AHC business is an “eco-
5 commerce” business and that:

6 my field of research carries over into what the un-informed might consider ‘personal’
7 expenses. It is my job to model a lifestyle of health and to continually research various
8 products and practices that meet the different needs and challenges of my clients towards
9 creating a life of wellbeing.

9 (*Id.*) Appellant claims his independent associate website with AHC is <http://gaian.amazonherb.net>.

10 Appellant states that his 2005 bank statements show his deposit activity and that
11 undesignated deposits could be gifts (such as a deposit of \$1,043 on December 27) or remuneration from
12 friends and colleagues for meals, entertainment, or other items he purchased for them. (*Id.* at pp. 2-3.)

13 Appellant contends that “[a]s messy as 2005 may seem, I believe I’ve made a clear case
14 to support that I was in fact engaged in a business for the purpose of making a profit.” (*Id.* p. 3.)

15 In appellant’s 2005 reply brief, dated January 27, 2010 (2005 ARB), appellant referenced
16 exhibits and documentation provided in his 2005 second reply brief, dated January 2, 2010, (2006
17 ASRB) that he earlier presented for his 2006 appeal, contending that the exhibits and documents
18 provided in the 2006 appeal show he undertook an activity to make a profit, was regularly engaged in
19 that activity, and commenced business operations. (2005 ARB at p. 1.) Appellant claims that the
20 evidence submitted shows he had training in the massage arts, liability insurance, business licenses,
21 worked as an independent contractor for AHC and Isagenix International, and used fictitious business
22 names such as Gaian, Gaian Project, and Sunyata. (*Id.*)

23 *Respondent’s 2005 Contentions*

24 Respondent contends deductions are allowed for ordinary and necessary expenses in
25 conducting a business, but that appellant failed to substantiate he was actively engaged in a trade or
26 business with continuity and regularity, failed to demonstrate the payments he made were to the vendors
27 pursuant to his schedules and failed to explain how they were ordinary and necessary business expenses.
28 (2005 ROB at pp. 2-5.) Respondent submits that the expenses claimed were either personal in nature or

1 were not adequately substantiated as ordinary and necessary business expenses. (2005 ROB at p. 6.) By
2 way of example, respondent identified the following deductions and stated that absent clear and direct
3 evidence of their business nature, they should be treated as nondeductible personal expenses:

- 4 1. Various entertainment expenses to Alpine Meadows, Ticketmaster, and Netflix;
- 5 2. Shopping expenses at Whole Foods Market, Rainbow Grocery, Thorn's Natural Food Store, and
6 Rainforest Bioenergetics;
- 7 3. Payments to regular utility providers, such as Comcast and Cingular.

8 Respondent claims that not only has appellant failed to substantiate these expenses as
9 business expenses, appellant conceded in his appeal letter that he has no records of any private massage
10 clients for 2005. (2005 ROB at p. 7.)

11 Respondent contends that unless an activity is engaged in for profit, no deduction is
12 allowed (citing IRC section 183). Respondent contends several factors are reviewed when determining
13 whether a taxpayer is engaged in an activity for profit (citing Treasury Regulation section 1.183-2(b)).¹³
14 (2005 ROB at p. 5.) In comparing these factors to appellant's expenses, respondent notes that appellant
15 deducted advertising expenses, but has not shown any indicia or copy of advertising, nor any other
16 typical indicia of a business, such as business cards, a business plan, a mileage journal detailing the car
17 and truck expenses, or billing statements for the legal and professional services. (2005 ROB at p. 7.)
18 Respondent states that although appellant claimed \$12,073.50 for other business property, no evidence
19 of such property has been provided. (*Id.*) As for the rent or lease of vehicles, machinery or equipment
20 deduction of \$3,324, respondent claims no indication has been provided of what was leased and their
21 purpose since appellant had no clients for 2005. (*Id.*)

22 Respondent claims that although appellant has demonstrated taking various seminars in
23 the massage arts, his evidence for the remaining factors are sorely lacking. (2005 ROB at p. 8.)
24 Respondent claims appellant's financial status indicates that he was solely dependent on his full time job
25 at Kabuki Springs & Spa and not dependent on his business activity to support his lifestyle. (*Id.*)

26 Respondent contends there is a significant element of personal pleasure or recreation in
27

28 ¹³ The factors discussed in Treasury Regulation section 1.183-2(b) are provided below in the applicable law section of this
Hearing Summary.

1 appellant's claimed business deductions and that respondent's denial should be sustained. (*Id.*)

2 Respondent contends that deductions are a matter of legislative grace, the burden is on
3 appellant to demonstrate respondent's findings were in error, and appellant has failed to satisfy this
4 burden. (2005 ROB at pp. 8-9.)

5 As for appellant's unreimbursed business expenses listed above, respondent states that
6 appellant failed to provide any documentation from his employer substantiating any of the expenses as
7 required; moreover, "it is difficult to understand the claim of over fourteen thousand dollars for 'other
8 business expenses' when, by all appearances, [a]ppellant was a standard W-2 wage employee." (ROB at
9 p. 9.) Respondent claims Kabuki Springs & Spa is a Japanese style bathing facility, whose website does
10 not indicate any offsite services are provided requiring travel. (*Id.*) Respondent claims that unless
11 appellant can show the claimed expenses were incurred at the request of his employer, these deductions
12 must be denied. (*Id.*)

13 *Appellant's 2006 Contentions*

14 Appellant contends respondent's conclusion that he is a wage earner (employee) and
15 cannot therefore be self-employed is flawed. (2006 AAL at p. 1.) Appellant contends the following
16 facts demonstrate that he is running his own business and can validate his business expenses:

- 17 1. He filed business licenses in Vacaville and San Francisco, when he lived there;¹⁴
- 18 2. He filed Schedules A and C for the past decade;
- 19 3. He maintained professional liability insurance because of his independent work;
- 20 4. He has several certifications showing substantial training;
- 21 5. He can verify being hired by numerous companies as an Independent Contractor as well as
22 rented professional space to practice out of;
- 23 6. He can verify his status as an Independent Associate for AHC and Isagenix International, as well
24 as provide e-commerce websites for these businesses;
- 25 7. He maintains other websites which relate to the different aspect of his business;
- 26 8. He can provide countless contacts for private clients and professional peers;

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28

¹⁴ Appellant claims he lived in Vacaville from 1999 to 2002 and in San Francisco from 2003 through 2007. (2005 AAL at p. 1.)

1 9. “[P]erhaps the most important fact, is that my father is a police officer...” and appellant would
2 not engage in tax fraud.

3 (*Id.* at pp. 1-2.)

4 Appellant contends he submitted bank statements and cancelled checks to validate his
5 claimed business expenses. (2006 ARB at p. 1.)¹⁵ Appellant contends that it is not mandatory for him
6 to show profits, since as he understands, it is not mandatory to make a profit in a private business for up
7 to five years, before it will be considered a hobby loss. (*Id.* at p. 2.) Appellant conceded that due to the
8 same factors that affected his business for 2005, he “managed to only acquire two one-time clients in
9 2006.” (*Id.*) Appellant contends he has clearly shown to respondent how his payments to Blockbuster,
10 Columbia House, and Netflix were related to his business. (*Id.* at p. 3.)

11 In appellant’s second reply brief, dated January 2, 2010, (2006 ASRB), appellant
12 provided the following documents: a copy of his 1996 Acupressure Diploma; 2000 Acupressure
13 Therapy Diploma; 2001 Certified TouchPro Practitioner certificate; American Massage Therapy
14 Association Insurance Memorandum (for coverage from February 1999 through January 2000); Allied
15 Professional Insurance Company policies (for coverage from March 2004 through March 2007, and
16 March 2009 through March 2010); a City of Vacaville Business License Tax Certificates, one expiring
17 April 30, 2001, the other April 30, 2010; City and County of San Francisco License Certificate for 2007;
18 a 2003 AHC bill/receipt for a purchase of \$81.50; a January 2005 AHC invoice for \$154.03; a
19 September 2006 AHC invoice for \$268.00; a November 2006 AHC invoice for \$57.02; an April 2007
20 AHC invoice for 148.29; a December 2009 AHC invoice for \$53.52; a list of compensation earnings
21 from Isagenix from November 15, 2006 through January 2, 2010.¹⁶ (2006 ASRB exhibits D1 through
22 D17.) Appellant contends this information demonstrates sustained business activity and shows he used
23 the following fictitious business names: Gaian, Gaian Project, and Sunyata. (2006 ASRB at p. 1.)

24 *Appellant’s Procedural Contention*

25 Appellant contends respondent failed to specify the kind of proof needed to allow the
26

27 ¹⁵ Appellant contends he submitted a tax payment for the 2006 tax year to prevent further accumulation of interest. (*Id.*)

28 ¹⁶ Board staff notes the total 2006 Isagenix earnings was \$100.10.

1 expenses. (2006 ARB at p. 1.) Appellant contends respondent initiated a 2006 Earning Withholding
2 Order for Taxes on March 16, 2009 and this action was “out of order” since appellant had not received
3 the 2006 NOA until March 30, 2009. (*Id.*) Appellant contends respondent contradicted itself, stating
4 appellant did not provide Schedules A & C, but then later stating it had a copy of his Schedule C. (*Id.*)
5 Appellant claims this “indicates the FTB’s intention to misguide the BoE in this matter.” (*Id.*)
6 Respondent contends the FTB proposed the 2005 assessment upon receiving his payment for 2006, even
7 though 2006 was under appeal, that he did not remit payment for 2005, but is appealing that year as
8 well, and that respondent has not pursued an assessment for 2004 indicates that had appellant remitted
9 payment for 2005, respondent would have pursued 2004. (2006 ARB at p. 2.) Appellant contends this
10 reveals respondent’s intent to pursue him as “an ‘easy mark.’” (*Id.*)

11 *Respondent’s 2006 Contentions*

12 Respondent contends the documents submitted by appellant were for personal expenses
13 and cannot be claimed as business expenses under Internal Revenue Code (IRC) section 162, as
14 incorporated by R&TC section 17201. (2006 ROB at p. 2.) Respondent contends that to be engaged in
15 a trade or business, the taxpayer must be involved in the activity with continuity, regularity and the
16 taxpayer’s primary purpose for engaging in the activity must be for income or profit. (*Id.*) Respondent
17 contends that appellant has not demonstrated he was actively conducting or carrying on a trade or
18 business. (*Id.*)

19 Respondent reiterated its position from its 2005 ROB, that in the case of an activity
20 engaged in by an individual, no deduction attributable to such activity is allowed under IRC section 183,
21 if it is not engaged in for profit, and that deductions are not allowable under IRC section 162 or 212 for
22 activities which are carried on primarily as a sport or hobby, or for recreation. (2006 ROB at p. 3.)
23 Respondent reiterated its position that the relevant factors (among others) include the manner in which
24 the taxpayer carries on the activity, the time and effort expended by the taxpayer, the taxpayer’s history
25 of income or losses with respect to the activity, and elements of personal pleasure or recreation.

26 Respondent contends that even if appellant were able to substantiate that he was
27 conducting a business activity for profit in 2006, and although appellant did not report any receipts or
28 sales income on line one of his schedule C, appellant has failed to show the expenses claimed were for

1 ordinary and necessary business expenses in carrying on his business under IRC section 162. (2006
2 ROB at pp. 3-4.) To be entitled to business expense deductions, respondent contends appellant must
3 substantiate he was engaged in a trade or business with continuity and regularity, for profit and also
4 provide evidence to (1) substantiate the payments were made to vendors or individuals reported as per
5 appellant's schedules and (2) documentation to support the payments were necessary and ordinary
6 expenses directly related to his ongoing Schedule C trade or business. (ROB at p. 4.) In contrast,
7 respondent contends that IRC section 262 provides that no deduction shall be allowed for personal,
8 living, or family expenses. (*Id.*)

9 Respondent claims that it reviewed the \$40,466.04 amount claimed on appellant's
10 Schedule C and determined that some of the expenses were either personal in nature or were not
11 adequately substantiated as ordinary and necessary business expenses. (*Id.*) In reviewing the
12 documentation provided, respondent concluded that appellant failed to provide any evidence that
13 unexplained payments, loans, or advances to individuals were business related; or that various payments
14 to Blockbuster, House Video Club, and Netflix and shopping expenses to Whole Foods Market,
15 Rainbow Grocery, and Rainforest Bioenergetics were other than personal. (ROB at p. 5.)

16 With respect to appellant's 2006 Schedule A itemized deductions, respondent contends
17 unreimbursed business expenses incurred by an employee in the course of his employment are reported
18 on Schedule A and that appellant failed to provide information regarding the nature and deductibility of
19 the alleged expenses. (*Id.*) Respondent claims the burden of proof is on appellant to substantiate such
20 deductions and appellant has failed to carry that burden. (*Id.*)

21 In response to appellant's procedural contentions, respondent contends they do not
22 address the issue before the Board, i.e., whether appellant has demonstrated error in the assessment.
23 (2006 Respondent's Reply Brief at p. 1.) Respondent also contends the Board, by regulation, has
24 determined that arguments regarding alleged violations of substantive or procedural rights, or based on
25 law that does not apply to the assessment of tax, are issues that it will not consider, since they are
26 beyond the Board's jurisdiction. (*Id.*)

27 Applicable Law

28 It is well settled that deductions and exclusions are a matter of legislative grace and are

1 allowable only where the conditions established by the legislature have been satisfied. (*New Colonial*
2 *Ice Co. v. Helvering*, (1934) 292 U.S. 435; *Appeal of Frederick A. Sebring*, 80-SBE-164, Dec. 9, 1980.)
3 Respondent's determination that a deduction or exclusion should be disallowed is presumed correct
4 (*Welch v. Helvering*, (1933) 290 U.S. 111; *Appeal of John A. and Julie M. Richardson*, 80-SBE-135,
5 Oct. 28, 1980), and appellant must prove his entitlement to the claimed deductions or exclusion.
6 (*Appeal of Ambrose L. and Alice M. Gordos*, 82-SBE-062, Mar. 31, 1982.) To overcome this
7 presumption, the taxpayer must introduce credible, competent, and relevant evidence to support his
8 assertions. (*Appeal of Oscar D. and Agatha E. Seltzer*, 80-SBE-154, Nov. 18, 1980) The failure of a
9 party to produce evidence within his control gives rise to a presumption that, if provided, such evidence
10 would be unfavorable to that party. (*Appeal of Don A. Cookston*, 83-SBE-048, Jan. 3, 1983.)

11 R&TC section 17201 conforms to IRC section 162, which allows a deduction for the
12 ordinary and necessary business expenses of carrying on a trade or business. The IRS requires expenses
13 claimed for a business carried on directly by an individual to be listed in Schedule C of his/her federal
14 return. (See Instructions to Schedule C, available online at [http://www.irs.gov/pub/irs-prior/i1040sc--](http://www.irs.gov/pub/irs-prior/i1040sc--2006.pdf)
15 2006.pdf, last viewed on September 29, 2010.) In order for a deduction to be allowed under IRC section
16 162, the taxpayer must be carrying on a trade or business. (*Weaver v. Comm'r*, T.C. Memo 2004-108.)
17 To be engaged in a trade or business, the taxpayer must be involved with the activity with continuity and
18 regularity and his primary purpose for engaging in the activity must be for income or profit; therefore, a
19 sporadic activity, a hobby or an amusement diversion does not qualify. (*Comm'r v. Groetzing* (1987)
20 480 U.S. 23, 35.)

21 R&TC section 17201 conforms to IRC section 212, which allows an individual to deduct
22 ordinary and necessary expenses paid or incurred for the production of income. The IRS requires
23 itemized deductions claimed as unreimbursed business expenses on Schedule A to be identified on IRS
24 Form 2106 or 2106-EZ, "Employee Business Expense." IRS Form 2106 is used by employees to report
25 ordinary and necessary business expenses relating to their job. (See 2006 IRS Form 2106 Instructions,
26 available online at <http://www.irs.gov/pub/irs-prior/i2106--2006.pdf>, last viewed on September 29,
27 2010.)

28 R&TC section 17201 conforms to IRC section 183 which provides that in the case of an

1 activity engaged in by an individual, if such activity is not engaged in for profit, no deduction
2 attributable to such activity shall be allowed (i.e., a deduction under IRC sections 162 or 212) except as
3 provided. IRC section 183(c) provides that an “activity not engaged in for profit” means an activity
4 other than one with respect to which deductions are allowable under IRC section 162 or 212. Thus, to
5 claim a deduction under IRC section 162 or 212, the taxpayer must show the activity was engaged in for
6 profit. Treasury Regulation 1.183-2(a) further provides that a deduction under IRC sections 162 and
7 212 is not allowed for activities carried on primarily for sport, hobby or recreation and that the
8 determination as to whether an activity is engaged in for profit is to be made by reference to objective
9 standards, taking into account the facts and circumstances of each case and greater weight is given to the
10 objective facts than to the taxpayer’s “mere statement of his intent.” The relevant factors include:

- 11 1. Manner in which the taxpayer carries on the activity, i.e., in a business like manner with
12 complete and accurate books and records;
- 13 2. Expertise of the taxpayer, i.e., study and preparation for the business;
- 14 3. Time and effort expended by the taxpayer in carrying on the activity;
- 15 4. Expectation that assets used in the activity may appreciate in value;
- 16 5. Success of the taxpayer in carrying on other similar or dissimilar activities;
- 17 6. Taxpayer’s history of income or losses with respect to the activity;
- 18 7. The amount of occasional profits;
- 19 8. The financial status of the taxpayer, i.e., whether the taxpayer does or does not have substantial
20 income from a source other than the activity; and
- 21 9. Elements of personal pleasure or recreation.

22 (Treas. Reg. § 1.183-2(b).)

23 IRC section 262, which California conforms to pursuant to R&TC section 17201,
24 subdivision (c), provides that no deduction is allowable for personal, living, or family expenses.

25 The Board will not consider, and does not have jurisdiction, to determine whether
26 appellant is entitled to a remedy for respondent’s actual or alleged violation of any substantive or
27 procedural right, unless the violation affects the adequacy of a notice, the validity of an action from
28 which a timely appeal was made, or the amount at issue in this appeal. (Cal. Code Regs., tit. 18, § 5412,

1 subd. (b)(5).)

2 STAFF COMMENTS

3 Appellant failed to timely file a 2005 return and then raised what appear to be frivolous
4 arguments as to why he was not required to do so. Appellant then filed his 2005 return in August 2007
5 claiming business expense and unreimbursed business expense deductions which exceeded his 2005
6 wage and interest income by \$11,817. For 2006, appellant's claimed business deductions exceeded his
7 wage income by \$19,099. Appellant did not report any gross sales/receipts related to his alleged
8 business.¹⁷ In discussing the nature of his business expenses for 2006, appellant contended that he is
9 always at work, except when he is sleeping and his business expenses related to items that included his
10 groceries, toiletries, and haircuts. Therefore, at the oral hearing, the Board may wish to first inquire
11 whether appellant simply claimed all of his expenses as deductible business expenses, and whether
12 appellant would be willing to concede some of the expenses as nondeductible personal, living, or
13 recreational expenses.

14 For the expenses appellant claims were related to his business operations, in order for
15 appellant to be allowed a deduction under IRC section 162, he must demonstrate with credible and
16 competent evidence that: (1) he continuously and regularly carried on a trade or business during 2005
17 and 2006, (2) the expenses incurred were ordinary and necessary for the business, and (3) the expenses
18 are supported with adequate documentation (e.g., receipts, contracts, invoices, etc.).

19 For appellant's unreimbursed business expenses, appellant must substantiate the expenses
20 and demonstrate how they were incurred as part of his employee relationship for the production of
21 income.

22 Appellant provided several training certificates to contend he engaged in a trade or
23 business. Such evidence demonstrates appellant was trained for the massage arts; however, at the oral
24 hearing, appellant will need to demonstrate he carried on his own business during 2005 and 2006 and
25 was not simply providing services as an employee to an employer.

26 In this regard, appellant provided evidence of professional liability insurance for 2005
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¹⁷ Assuming appellant charged any clients for 2005 or 2006 related to an independent business appellant claims he carried on, then the amounts received should have been reported as a gross receipt/sale on appellant's Schedule C.

1 and 2006 and claimed deductions of \$99 each year relating to insurance. Such evidence demonstrates
2 appellant held insurance; however, appellant reported no gross receipts/sale for any personally run
3 business operations for 2005 and 2006 and admits a lack of personal clients for 2005 and 2006.
4 Therefore, at the oral hearing, appellant should be prepared to discuss why he purchased massage
5 therapy insurance, and whether, without any clients, such expenses were necessary for his separate
6 business operations.

7 It appears the business licenses provided by appellant do not cover either the 2005 or
8 2006 tax years at issue in this appeal. (See 2006 ASRB exhibit D9.)

9 Appellant's 2005 AOB, exhibit P provides a list of four purported "past independent
10 contracts" from 1999 through 2002. Since this information predates 2005 and 2006 by several years,
11 and since appellant concedes a lack of clients for 2005 and 2006, it does not appear such evidence
12 supports appellant's contention of running a business in 2005 or 2006.

13 Appellant's 2005 AOB exhibits Q-1 through Q-3 appear to be copies of appellant's
14 personal checking account balance statements from January 2005 through December 2005.
15 Respondent's 2006 ROB exhibit D, p. 5 through 65, also appear to be copies of appellant's personal
16 checking account statements and canceled check copies from 2006. These statements are in appellant's
17 name and Board staff could not tell from the information provided whether specific items were personal
18 in nature or were related to an alleged trade or business carried on by appellant. Appellant's failure to
19 establish the business nature of any of these items could result in the conclusion that they merely
20 represent a record of appellant's entire bank statements and nothing more.

21 Board staff visited the corporate website for AHC at www.amazonherb.net/Default.aspx
22 (last visited on September 30, 2010) and learned that AHC (at least currently) offers individuals the
23 opportunity to run a "home-based business" through features such as the Amazon Prosperity Kit:

24 The Amazon Prosperity Kit gives everyone participating in the Amazon Herb business
25 opportunity an introductory package of tools and materials, a personalized Amazon Herb
26 website, immediate access to the Amazon Business Suite and the opportunity to qualify
for commission income.

27 (See <http://www.amazonherb.net/Amazon-Business-in-a-Box.aspx>, last viewed on September 30, 2010.)

28 Appellant's 2006 ASRB exhibits include invoices from AHC and indicate some purchases were made;

1 however, appellant should be prepared to explain at the oral hearing how the items purchased were used
2 in his business. Appellant should also be prepared to reconcile these purchases to the fact that he
3 reported zero gross receipts/sales (or commission income) for 2005 and 2006. Appellant should also be
4 prepared to reconcile any AHC related expenses to his claimed business expense deductions.

5 Assuming the Board believes appellant was regularly engaged in a business (separate
6 from his role as an employee) appellant will also need to link the expenses claimed on his Schedule C to
7 his business operations and provide documentary support for such expenses. For example, appellant
8 claimed over \$12,000 for 2005 and \$12,000 for 2006 for the rental of property used in his business.
9 Appellant should be prepared to explain the nature, location and use of such property, from whom he
10 rented it, and should provide some documentation (*e.g.*, rental agreement) showing that the property was
11 actually rented. Appellant should also be prepared to provide similar explanations, along with
12 documentary evidence and receipts for all of the business expenses claimed on his Schedules A and C to
13 overcome the presumption that respondent correctly disallowed these expenses.

14 With respect to appellant's contention that he had a profit motive and should therefore be
15 allowed his claimed business deductions, Board staff notes "profit motive" alone is insufficient to claim
16 a business deduction; *i.e.*, appellant must also (1) independently satisfy the statutory requirements of
17 IRC section 162 (regularly carrying on a business) or IRC section 212, that appellant's activity was for
18 the production of income; and (2) produce documentary evidence supporting the claimed expense
19 deduction relates to an aspect of his business. IRC section 183 further requires that appellant must
20 demonstrate the activity giving rise to the deduction was engaged in for profit. In performing this profit
21 analysis, greater weight is given to applying the profit factors than to appellant's assertion of a profit
22 motive. In reviewing these factors to appellant's evidence, Board staff was unable to separate the
23 recreational and personal nature of appellant's activities from his alleged business activities, since it
24 does not appear appellant kept separate personal and business records. It appears appellant has training
25 for the massage arts, but the record is silent as to appellant's marketing and sales training with respect to
26 AHC or Isagenix International and appellant did not report gross sales of any product or services. As for
27 appellant's time and effort running his own business, it appears appellant was a fulltime employee
28 during the relevant tax years and he has indicated this left him little or no time to pursue his own

1 business operations. As for the efforts required for business activities relating to his employer, appellant
2 has not explained how his unreimbursed business expenses were applied in the employee activities he
3 engaged in on a day-to-day basis. Appellant does not discuss his prior business successes; further, it
4 appears appellant relied primarily on his employee wages for his income in 2005 and 2006. Finally,
5 although appellant contends his personal wellbeing was required for his business operations (including
6 groceries, haircuts, toiletries, and keeping up to date on cultural knowledge, such as movies and Netflix),
7 it appears to Board staff that such expenses could objectively be categorized as personal and/or for
8 recreation.

9 Accordingly, at the oral hearing, appellant should be aware that he bears the burden of
10 proof to establish he was engaged in a business. He should specify the business nature of the claimed
11 deductions and provide substantiating documentation showing his deductions related to activities
12 engaged in for profit. If the Board determines appellant has failed to meet this burden, then
13 respondent's action should be sustained.

14 As for appellant's procedural contentions, unless appellant can demonstrate that
15 respondent's alleged procedural violations resulted in an incorrect tax assessment, it does not appear the
16 Board has jurisdiction to consider such issues.

17 Finally, as noted above, prior to the oral hearing respondent should review the 2005 NPA
18 calculation and inform Board Proceedings whether the 2005 assessment calculation took into account
19 the standard deduction, or should be reduced accordingly.

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