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

12 In the Matter of the Appeal of:) **HEARING SUMMARY**
 13)
 14) **PERSONAL INCOME TAX APPEAL**
 15)
 16 **KEITH COSTELLO**) Case No. 432902

<u>Years</u>	<u>Proposed Assessments¹</u>	
	<u>Tax</u>	<u>Penalty</u>
2002	\$17,804	\$ 863.01 ²
2003	13,114	2,622.80 ³

17 Representing the Parties:

18 For Appellant: Glenn R. Abel, Attorney at Law
 19 For Franchise Tax Board: Diane L. Ewing, Tax Counsel III

20 **QUESTIONS:** (1) Whether appellant has shown that the Internal Revenue Service (IRS) has not
 21 issued a final federal determination for purposes of Revenue and Taxation Code
 22 (R&TC) section 18622 with respect to either of the appeal years.
 23 (2) Whether appellant has overcome the presumption that respondent's
 24 determinations for the appeal years, based on federal audit reports, are correct.
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 27 ¹ At the oral hearing, respondent will provide the amount of accrued interest as of the date of the hearing.

28 ² This amount represents a post-amnesty penalty.

³ This amount represents an accuracy-related penalty.

1 (3) Whether appellant has shown that he is entitled to various deductions, including
2 some that he did not claim on his tax returns for the appeal years.

3 (4) Whether appellant has shown that an accuracy-related penalty imposed for 2003
4 should be abated.

5 (5) Whether the Board has jurisdiction to adjudicate a post-amnesty penalty for 2002.

6 HEARING SUMMARY

7 Background

8 Appellant, a self-employed electrician, filed California resident tax returns for 2002 and
9 2003 on unspecified dates. As part of its review of appellant's returns, respondent obtained from the
10 IRS on January 20, 2006, a FedStar IRS Data Sheet (federal audit report), dated October 7, 2005, for
11 each of those years. Respondent points out that the federal audit report for 2002 shows that appellant
12 reported on his federal tax return for that year taxable income of \$19,406. Respondent also states that
13 the federal audit report shows that the IRS increased appellant's taxable income for 2002 by the amount
14 of \$194,073 as a result of numerous adjustments to income and expenses on Schedules C and A of
15 appellant's return. Similarly, respondent points out that the federal audit report for 2003 shows that
16 appellant reported on his federal return for that year taxable income of zero. Respondent also states that
17 the federal audit reports shows that the IRS increased appellant's taxable income for 2003 by the amount
18 of \$175,046 as a result of several adjustments to Schedule C of appellant's return.

19 Respondent further states that it followed the respective federal audit reports in increasing
20 appellant's California taxable income for each appeal year by the same amount as the increase by the
21 IRS of his federal taxable income for that year. Respondent issued NPA's for the appeal years on
22 March 7, 2007. On the NPA for 2002, respondent proposed the assessment of additional tax of
23 \$17,502.00, a post-amnesty penalty of \$863.01, and associated interest. On the NPA for 2003,
24 respondent proposed the assessment of additional tax of \$13,114.00, an accuracy-related penalty of
25 \$2,622.80, and associated interest.

26 Appellant protested the NPA's issued by respondent in a letter to respondent dated
27 May 7, 2007. In that letter, appellant requested an oral protest hearing. In the alternative, he requested
28 respondent to defer making its proposed assessments final until what appellant characterized as the IRS

1 reaudits for 2002 and 2003 were final and appellant had the opportunity to file amended California
2 returns reflecting the results of those reaudits. On June 4, 2007, respondent issued a Notice of State Tax
3 Due (Notice) to appellant for each of 2002 and 2003. In a letter to respondent dated June 13, 2007,
4 appellant objected to the issuance of the Notices in part because they were issued before appellant
5 received an oral protest hearing. In that regard, appellant argued that the issuance of the Notices was
6 illegal on various statutory and constitutional grounds and requested respondent to rescind the Notices.
7 Respondent states that it issued the Notices shortly before it received appellant's protests on May 10,
8 2007, and, at an unspecified time after it received the protests, withdrew them.

9 In a letter to appellant dated September 6, 2007, respondent acknowledged that it
10 received appellant's protests for 2002 and 2003. In addition, respondent noted that appellant stated in
11 his protest letter that his matter had been appealed with the IRS and a reaudit by the IRS was pending.
12 Respondent requested appellant to provide documents from the IRS establishing that the IRS was either
13 reviewing his matter or had completed its review. Respondent also stated that "[a] hearing at this time
14 will serve no purpose if the IRS does not change or has not changed their adjustments, since our notice
15 was based on their adjustments." Finally, respondent requested appellant to provide any information by
16 September 19, 2007, and stated that if it did not receive such information by that date, "our notice will
17 be affirmed and collection action will continue." (App. Ltr., Exhibit 7.)

18 In a letter to respondent dated September 11, 2007, appellant replied that he was in the
19 initial stages of the appeal process with the IRS and that no federal determination regarding his matter
20 had been reached. Appellant further stated that, as a result, "[he] was also of the opinion that a
21 Franchise Tax Board (hereinafter the 'FTB') Hearing at this time would serve no purpose, since the
22 FTB's adjustments are based on the IRS's adjustments and no action on same has transpired." (App.
23 Ltr., Exhibit 8.) Appellant then stated that, after a determination had been reached by the IRS, he would
24 inform respondent regarding the resulting adjustments.

25 Appellant also complied with respondent's request for information by attaching a letter to
26 him from the San Francisco Appeals Office of the IRS dated August 3, 2007. In the attached letter, that
27 office explained that "[w]hat we do is review and resolve disputes. We do this in a fair and impartial
28 manner by using the law and judicial decisions to weigh the facts. We conduct our reviews by: (1)

1 telephone, (2) mail, and/or (3) personal interviews.” (App. Ltr., Attachment to Exhibit 8.) Enclosed
2 with the attached letter was “Publication 4165 Introduction to Collection Due Process Hearings.”

3 Respondent states that, after reviewing appellant’s letter of reply and all other available
4 information, it determined that the IRS had issued final assessments for both appeal years. Respondent
5 further states that, as a result, it issued Notices of Action (NOA’s) on October 12, 2007, affirming its
6 NPA’s for those years. The NOA’s stated that respondent had not received the information requested in
7 its letter of September 6, 2007, and that, as a result, its NPA’s were affirmed in accordance with the
8 federal audit reports of October 7, 2005.⁴

9 Appellant filed a timely letter of appeal, dated October 29, 2007, with the Board
10 Proceeding Division. Attached to that letter of appeal was a letter to respondent of the same date. In the
11 attached letter to respondent, appellant stated that he was still in the initial stages of the appeal process
12 with the IRS and criticized respondent for affirming its NPA’s until a reaudit by the IRS had been
13 completed. Appellant also stated that he reiterated his request for an oral protest hearing and demanded
14 that respondent rescind its NOA’s for the appeal years because, in his view, a hearing before the Board
15 at this time was premature.

16 Contentions

17 Appellant contends that the entire amount of the tax, penalties, and interest in this matter
18 should be abated. Appellant emphasizes that he has filed his appeal as a protective filing and that a
19 hearing before the Board should not occur until the IRS appeals process has been completed. He alleges
20 that his federal appeal is still being undertaken before the IRS Appeals Office. Appellant cites Internal
21 Revenue Code (IRC) section 6320-1(e) for the proposition that he is “entitled to challenge the validity
22 and amount of the Tax liability proposed against the Taxpayer, if the Taxpayer has not been afforded the

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28 ⁴ Respondent now acknowledges that the NOA’s mistakenly stated that respondent had not received the information
requested in respondent’s letter of September 6, 2007.

1 opportunity to dispute the tax liability.”⁵ (App. Ltr., p. 8.) Appellant apparently alleges that his
2 previous counsel did not afford him the opportunity to dispute his tax liability because the previous
3 counsel failed to assert certain expenses and other large deductions at the original federal audit.
4 Appellant takes the position that when all of his expenses, other deductions, and income for the appeal
5 years are properly taken into account at a federal reaudit, his federal and California tax liability for those
6 years will be dramatically reduced. Appellant also argues that respondent’s issuance of the NOA’s for
7 the appeal years was illegal because they were allegedly contrary to the provisions of R&TC section
8 19044, subdivision (a), and violated the due process of the United States Constitution. R&TC section
9 19044, subdivision (a), provides that if a taxpayer files a protest, respondent shall reconsider its
10 assessment of the deficiency and grant the taxpayer an oral hearing if he has requested such a hearing in
11 his protest.

12 Respondent contends that appellant has not shown that the determinations made by the
13 IRS are not final. Respondent also contends that appellant has not overcome the presumption that
14 respondent’s determinations for the appeal years, based on federal audit reports, are correct. With
15 regard to its first contention, respondent cites IRC section 6203, which provides that an assessment shall
16 be made by recording the liability of the taxpayer by the Secretary of the Treasury in accordance with
17 pertinent rules and regulations. Respondent also points out that Treasury Regulation section 301.6203-1
18 provides, in pertinent part, that an assessment shall be made by an assessment officer of the IRS signing
19 a summary record of assessment. That section provides further that the summary record, through
20 supporting records, shall provide identification of the taxpayer, the character of the liability assessed, the
21 taxable period, if applicable, and the amount of the assessment. Finally, that section provides that the
22 date of the assessment is the date the summary record is signed by an assessment officer. Respondent
23 takes the position that an Individual Master File (IMF) transcript contains all of the information required
24

25 ⁵ Staff notes that IRC section 6320-1(e) does not exist. However, staff further notes that IRC section 6320 is generally
26 concerned with notice and the opportunity for hearing upon filing of notice of federal tax lien and that Treasury Regulation
27 section 301.6320-1(e) provides, in pertinent part, that a taxpayer may raise challenges to the existence or amount of the
28 underlying tax liability, including a liability reported on a self-filed return, at a Collection Due Process (CDP) hearing for any
period specified on the CDP Notice if the taxpayer did not receive a statutory notice of deficiency for that tax liability or did
not otherwise have an opportunity to dispute the tax liability. Treasury Regulation section 301.6320-1(d) provides generally
that if a taxpayer requests a CDP hearing under IRC section 6320(a)(3)(B) (and does not withdraw the request), the CDP
hearing will be held with the IRS Office of Appeals.

1 under Treasury Regulation section 301.6203-1.

2 Respondent states that it requested appellant's IMF's for the appeal years to confirm that
3 the federal determinations for those years were final and that it received the IMF's at some unspecified
4 date. The IMF's are dated March 21, 2008. With regard to 2002, respondent states that the IMF for that
5 year (Resp. Br., Exhibit J) shows that (1) the IRS opened an examination of appellant's account on or
6 about October 16, 2003; (2) the examination resulted in an assessment of additional tax on or about
7 November 21, 2005; and (3) the examination by the IRS closed on or about the latter date. With regard
8 to 2003, respondent states that the IMF for that year (Resp. Br., Exhibit K) shows that (1) the IRS
9 opened an examination of appellant's account on or before June 9, 2005; (2) the examination resulted in
10 an assessment of additional tax on or about November 21, 2005; and (3) the examination by the IRS
11 closed on or about the latter date.

12 Respondent argues that the letter of August 3, 2007, from the IRS to appellant and the
13 attached "Publication 4165 Introduction to Collection Due Process Hearings" do not show that the
14 federal determinations for the appeal years were not final because that publication indicates that the
15 issue of whether the taxpayer actually owes the tax may be considered only under limited circumstances,
16 including whether the taxpayer previously had an opportunity to dispute the tax. In that regard,
17 respondent alleges that various entries on the IMF's for the appeal years demonstrate that the IRS either
18 did not consider whether appellant owed tax under such circumstance or determined that tax was owed.
19 Finally, respondent states that documents appellant recently submitted to respondent (Resp. Br., Exhibit
20 L) do not support his contention that the IRS has not yet made final federal determinations for the appeal
21 years. Respondent invites appellant to submit any additional documentation that he receives from the
22 IRS establishing revision or revocation by the IRS of its determinations.

23 With regard to its other contention, respondent relies heavily upon the *Appeal of Sheldon*
24 *I. and Helen A. Brockett (Brockett)* (86-SBE-109), decided by the Board on June 18, 1986. In *Brockett*,
25 the Board stated that it is well settled that respondent's determination based on a federal audit report is
26 presumptively correct and that the burden is on the taxpayer to show that the determination is erroneous.
27 Respondent takes the position that appellant has offered only unsupported assertions to overcome the
28 presumption that respondent's determination here is correct and, for that reason, has not satisfied his

1 burden of proof. Respondent also relies heavily upon the *Appeal of Robert R. Telles (Telles)* (86-SBE-
2 061), decided by the Board on March 4, 1986. In *Telles*, the Board stated that the taxpayer bears the
3 burden of establishing his entitlement to a claimed deduction and that, in order to carry that burden, he
4 must point to an applicable statute and show by credible evidence that he comes within its terms.
5 Respondent alleges that appellant has not presented any evidence of entitlement to the claimed
6 deductions that were disallowed by the IRS. Again, respondent requests appellant to submit for its
7 review any documents that prove he is entitled to some or all of the deductions that have been
8 disallowed.

9 Finally, respondent addresses appellant's position that he was deprived of due process by
10 relying on the *Appeals of Walter R. Bailey (Bailey)* (92-SBE-001), decided by the Board on February 20,
11 1992. In *Bailey*, the Board noted that the concern of the taxpayer there over due process failed to
12 consider that due process is satisfied with respect to tax matters as long as an opportunity has been given
13 to question the validity of a tax at some stage of the proceedings.

14 Applicable Law

15 R&TC section 18622, subdivision (a), provides, in pertinent part, that if the amount of
16 gross income or deductions of a taxpayer on a federal tax return is changed or corrected by the IRS, that
17 taxpayer shall report the change or correction within six months after the final federal determination and
18 shall concede the accuracy of the determination or state in what respect that it is erroneous. R&TC
19 section 19060, subdivision (b), provides, in pertinent part, that if, after the six-month period required in
20 section 18622, a taxpayer or the IRS reports a change or correction by the IRS, a notice of deficiency
21 assessment resulting from the adjustment may be mailed to the taxpayer within four years from the date
22 that the taxpayer or the IRS notifies respondent of that change or correction.

23 California Code of Regulations, title 18, section 19059, subdivision (a), provides, in
24 pertinent part, that notification of federal changes under R&TC section 18622 shall be reported by
25 mailing to respondent the original or a copy of the final determination as well as any other data upon
26 which such final determination is claimed. Subdivision (e) of Regulation section 19059 defines a final
27 determination as an irrevocable determination or adjustments of a taxpayer's federal tax liability from
28 which there exists no further right of either administrative or judicial appeal.

1 It is well settled that respondent's determination based on a federal audit report is
2 presumptively correct and that the burden is on the taxpayer to show that the determination is erroneous.
3 (*Appeal of Sheldon I. and Helen A. Brockett, supra.*) Unsupported assertions do not overcome the
4 presumption of the correctness of that determination. (*Appeal of Aaron and Eloise Magidow*, 82-SBE-
5 274, Nov. 1, 1982.)

6 It is also well settled that a presumption of correctness attends respondent's
7 determinations as to issues of fact and that appellant has the burden of proving such determinations
8 erroneous. (*Appeal of Oscar D. and Agatha E. Seltzer*, 80-SBE-154, Nov. 18, 1980.) To overcome the
9 presumed correctness of respondent's finding as to issues of fact, a taxpayer must introduce credible
10 evidence to support his assertions. (*Appeal of Oscar D. and Agatha E. Seltzer, supra.*) When the
11 taxpayer fails to support his assertion with such evidence, respondent's determinations must be upheld.
12 (*Appeal of Oscar D. and Agatha E. Seltzer, supra.*) The failure of a party to introduce evidence within
13 his control gives rise to the presumption that, if provided, the evidence would be unfavorable to him.
14 (*Appeal of Don A. Cookston*, 83-SBE-048, Jan. 3, 1983.)

15 The Board has further stated that the taxpayer bears the burden of establishing his
16 entitlement to a claimed deduction. (*Appeal of Robert R. Telles, supra.*) The Board has also stated that,
17 in order to carry his burden, he must point to an applicable statute and show by credible evidence that he
18 comes within its terms. (*Appeal of Robert R. Telles, supra.*) Finally, the Board has stated that
19 unsubstantiated assertions by the taxpayer are not sufficient to satisfy his burden of proof. (*Appeal of*
20 *Robert R. Telles, supra.*)

21 California Constitution, Article III, section 3.5, subdivision (a), provides that an
22 administrative agency has no power to declare a statute unconstitutional, or to refuse to enforce a statute
23 on the basis of its being unconstitutional, unless an appellate court has made a determination that the
24 statute is unconstitutional. Furthermore, the Board has a well-established policy of abstention from
25 deciding constitutional questions in an appeal involving proposed assessments of tax. (See, e.g., *Appeal*
26 *of Maryland Cup Corp.*, 70-SBE-010, Mar. 23, 1970.) The Board has also noted that due process is
27 satisfied with respect to tax matters as long as an opportunity is given to question the validity of a tax at
28 some stage of the proceedings. (*Appeals of Walter R. Bailey, supra.*) In that regard, the Board pointed

1 out that it has long been held that more summary proceedings are permitted in the field of taxation
2 because taxes are the lifeblood of government and their prompt collection is critical. (*Appeals of Walter*
3 *R. Bailey, supra.*) Finally, the Board has recently reiterated its position that it has no authority to
4 address a taxpayer's complaints about procedural issues regarding their dealings with respondent during
5 audit or protest. (*Appeals of Robert E. Wesley and Jerry J. Couchman (Wesley)*, 2005-SBE-002, Nov.
6 15, 2005 (citing *Appeals of Fred R. Dauberger, et al.*, 82-SBE-082, Mar. 31, 1982).)

7 R&TC section 19164, subdivision (a)(1)(A), provides that an accuracy-related penalty
8 shall be imposed under that part and shall be determined in accordance with IRC section 6662, except as
9 otherwise provided. IRC section 6662(a) provides that if that section applies to any portion of an
10 underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to
11 20 percent of the portion of the underpayment to which it applies. IRC section 6662(b) provides, in
12 pertinent part, that the section will apply to any portion of the underpayment that is attributable to (1)
13 negligence or disregard of rules or regulation or (2) any substantial understatement of income tax.

14 IRC section 6662(c) provides that, for purposes of the section, "negligence" includes any
15 failure to make a reasonable attempt to comply with the provisions of the IRC. IRC section
16 6662(d)(1)(A) provides that, in general, there is a "substantial understatement" of income tax for any
17 taxable year if the amount of the understatement for the taxable year exceeds the greater of (i) 10 percent
18 of the tax required to be shown on the return for the taxable year or (ii) \$5,000. IRC section 6662(d)(2)
19 provides, in pertinent part, that the term "understatement" means the excess of (i) the amount of tax
20 required to be shown on the return for the taxable year over (ii) the amount of tax imposed which is
21 shown on the return. IRC section 6662(d)(2)(B)(i) provides that the amount of the understatement of tax
22 is reduced by the portion of the understatement that is attributable to the tax treatment of any item by the
23 taxpayer if there is or was "substantial authority" for such treatment. IRC section 6662(d)(2)(B)(ii)
24 provides, in pertinent part, that the amount of the understatement of tax is also reduced by the portion of
25 the understatement that is attributable to any item if "(I) the relevant facts affecting the item's tax
26 treatment are adequately disclosed in the return or in a statement attached to the return and (II) there is a
27 'reasonable basis' for the tax treatment of such item by the taxpayer". IRC section 6664(c)(1) provides,
28 in pertinent part, that no penalty shall be imposed under section 6662 on any portion of an underpayment

1 if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith
2 with regard to that portion.

3 R&TC section 19730 provides that respondent shall administer a tax amnesty program
4 for taxpayers. R&TC section 19731 provides in pertinent part that the tax amnesty program shall be
5 conducted during a two-month period beginning February 1, 2005, and ending March 31, 2005,
6 inclusive, or during a timeframe ending no later than June 30, 2005, under R&TC section 19733. R&TC
7 section 19732, subdivision (a)(1), provides generally for a waiver of all unpaid penalties and fees for
8 each taxable year for which tax amnesty is allowed but only to the extent of the amount of any penalty
9 or fee that is owed as a result of previous nonreporting or underreporting of tax liabilities or prior
10 nonpayment of any taxes previously assessed or proposed to be assessed for that taxable year. R&TC
11 section 19733 defines the requirements for those taxpayers seeking tax amnesty. R&TC section
12 19777.5, subdivision (a)(2), states that, for amounts that are due and payable on the last day of the
13 amnesty period, there shall be added to the tax for each taxable year for which amnesty could have been,
14 but was not, requested an amount equal to 50 percent of the accrued interest beginning on the last date
15 prescribed by law for payment of the tax and ending on the last day of the amnesty period specified in
16 section 19731. R&TC section 19777.5, subdivision (d), provides that provisions relating to deficiency
17 assessments shall not apply to the assessment or collection of the post-amnesty penalty. R&TC section
18 19777.5, subdivision (e)(1), provides generally that a taxpayer may not file a claim for refund for any
19 amount paid in connection with the post-amnesty penalty, except as provided in subdivision (2). R&TC
20 section 19777.5, subdivision (e)(2), provides that a taxpayer may file a claim for any amounts paid to
21 satisfy the post-amnesty penalty on the grounds that the amount of the penalty was not properly
22 computed by respondent.

23 STAFF COMMENTS

24 Appellant should provide 14 days before the hearing in this matter documentary evidence
25 substantiating his entitlement to all the deductions that he still claims and be prepared to explain at the
26 hearing why those deductions were incorrectly disallowed by the IRS and respondent. In particular,
27 appellant should provide documentary evidence substantiating his cost of goods sold (as well as other
28 business expenses) in his business as an electrician. In addition, he should also provide during the 14-

1 day period of time documentary evidence establishing that his federal appeal has not been concluded.

2 The documentary evidence should be mailed, with a copy to respondent, to:

3 Claudia Madrigal
4 State Board of Equalization
5 Board Proceedings Division
6 450 N Street, MIC:80
7 Sacramento, CA 95814

8 At the hearing, appellant should be prepared to establish that he did not waive his right to
9 an oral hearing under R&TC section 19044, subdivision (a), and to discuss the legal consequences in
10 light of *Bailey* and *Wesley* if he did not make such a waiver. Appellant should also be prepared to
11 address at the hearing whether the accuracy-related and post-amnesty penalties should be abated, and, if
12 so, on what grounds.

13 It appears to staff that respondent has implicitly taken the position that November 21,
14 2005, or somewhat later, is the date of the final federal determination for each appeal year. Staff notes
15 that, if respondent was notified of final federal determinations for those years on or after November 21,
16 2005, the issuance of NPA's for those years on March 7, 2007, falls well within the four-year period
17 stated in R&TC section 19060, subdivision (b). Respondent should be prepared at the hearing to
18 identify precisely the final federal determinations for the appeal years and to provide the exact dates on
19 which it received those final federal determinations. Respondent should also be prepared to address
20 what further action it will take if appellant submits additional documentation from the IRS purporting to
21 establish revision or revocation by the IRS of its determinations or that the matters are still under
22 consideration by the IRS.

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