OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	)	OTA Case No. 18011446
	)	
LANTIN ENTERPRISE, INC.	)	Date Issued: July 18, 2018
	)	
	)	
	)	

OPINION

Representing the Parties:

For Appellant: Cecil Lantin, President

For Respondent: Leah Thyberg, Tax Counsel

For Office of Tax Appeals: Tom Hudson, Tax Counsel III

M. GEARY, Administrative Law Judge: Pursuant to California Revenue and Taxation Code section 19045,[1] Lantin Enterprise, Inc. (appellant) appeals from the action of the Franchise Tax Board (FTB) denying appellant's protest of a proposed assessment of additional tax of $1,538.53 and an accuracy-related penalty of $307.71, plus interest, for the 2004 tax year.

ISSUES

1. Whether appellant is liable for the additional tax (and applicable interest, if any) based on a federal audit adjustment.
2. Whether appellant is liable for the accuracy-related penalty (and applicable interest, if any).

FACTUAL FINDINGS

1. Appellant, a manufacturer, filed a timely California Corporation Franchise or Income Tax Return (Form 100) for the 2004 tax year, reporting California net income of $4,095.00, and paying the $800.00 annual minimum tax.

[1] Unless otherwise indicated, all "Section" references are to sections of the California Revenue and Taxation Code.

2. The Internal Revenue Service (IRS) audited appellant's 2004 federal return. According to the copy of appellant's federal "Business Master File" (BMF) transcript, on March 8, 2009, the IRS increased appellant's taxable income by $190,779.00, from $3,269.00 reported to $194,048.00 determined by audit, and increased the federal tax by $58,438, from $490 reported to $58,928 determined by audit. The IRS also imposed an accuracy-related penalty of $11,687 (20 percent of the increase).[2]
3. According to FTB, on April 9, 2009, FTB issued a Notice of Proposed Assessment to appellant increasing appellant's 2004 California taxable income from $4,095.00 to $194,874.00, consistent with the federal adjustment.
4. According to the March 7, 2014 "Income Tax Examination Changes" (IRS Form 4549-A) provided by FTB, the IRS revised the previous audit adjustment from $190,779.00 to $22,359.00 (a $168,420.00 reduction), which left federal taxable income of $25,628.00 ($3,269.00 + $22,359.00 = $25,628.00), a "corrected tax liability" of $3,354, and a reduced accuracy-related penalty of $708.80. The reason for the accuracy-related penalty is not stated.
5. An IRS Form 886-A shows that the IRS considered four areas for possible adjustment after the initial $190,779.00 increase: cost of goods sold, other income, rents, and interest expense. It also indicates the IRS compared amounts reported by appellant in its return with amounts determined by audit for each area. For cost of goods sold and interest expense, the form states the amount reported matched the amount determined by audit. According to the form, appellant reported $168,420 in other income, but the IRS determined that appellant had no reportable other income, which is why the increase first determined was later reduced by that amount. Finally, the form does not indicate what appellant reported or what the IRS determined regarding rents paid, but it does indicate the IRS allowed no adjustment for rent.
6. On March 29, 2016, FTB again followed the new federal determination and issued a Notice of Action that also reduced appellant's taxable income by $168,420.00, resulting in California taxable income of $26,454.00, a reduced assessment of additional tax of $1,538.53, and an accuracy-related penalty of $307.71. This timely appeal followed.

[2] We base some findings of fact on statements made or documents provided by FTB and not contradicted by appellant.

DISCUSSION

Issue 1 - Whether appellant is liable for the additional tax based on a federal audit adjustment.

Section 18622(a) provides that a taxpayer shall either concede the accuracy of a federal determination or explain how it is wrong. A deficiency assessment based on a federal audit report is presumptively correct, and the taxpayer bears the burden of proving that the determination is erroneous. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Sheldon I. and Helen E. Brockett*, 86-SBE-109, June 18, 1986.)[3] Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof with respect to an assessment based on a federal action. (*Appeal of Aaron and Eloise Magidow*, 82-SBE-274, Nov. 17, 1982.)

Income tax deductions are a matter of legislative grace, and the taxpayer bears the burden of establishing entitlement to the deductions claimed. (*Appeal of James C. and Monablanche A. Walshe*, 75-SBE-073, Oct. 20, 1975; *New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435.) In order to carry that burden, a taxpayer must point to an applicable statute and show by credible evidence that the transactions in question come within its terms. (*Appeal of Robert R. Telles*, 86-SBE-061, Mar. 4, 1986.) The FTB's denials of claimed deductions are presumed correct until the taxpayer has proven his entitlement. (*Appeal of Gilbert W. Janke*, 80-SBE-059, May 21, 1980.)

Here, appellant argues that the IRS and FTB should have reduced its taxable income by $80,610 to reflect rent appellant paid to its shareholders, Cecil & Maria Belen Lantin (the Lantins). Appellant indicated the Lantins did business as a sole proprietorship prior to 2004, and during those years, they owned the business premises, and owned and operated the business, in their individual capacities. Appellant alleges that the business incorporated in 2003, and thereafter the Lantins continued to own the business premises, which they rented to appellant. Appellant provided what purports to be the first page of the Lantins' federal Schedule E (Supplemental Income and Loss) from their 2004 federal tax return, which shows rental income of $80,610 from "Rental Property Bldg" and it argues it paid that rent to the Lantins, but neglected to enter a deduction for rent on its 2004 return. Appellant also submitted the first page of appellant's federal income tax return (Form 1120) for 2004, showing no entry on Line 16 for "Rents" paid. Appellant has provided no other evidence to show appellant paid rent in 2004. Appellant asserts that the first auditor allowed the deduction, but the second auditor disallowed it

[3] Published decisions of the Board of Equalization, designated by "SBE" in the citation, are available on that Board's website at: http://www.boe.ca.gov/legal/legalopcont.htm.

without justification. It also argues it is grossly unfair to tax the Lantins on their rental income but not allow their corporation the benefit of the deduction for rental payments.

FTB's position is that the federal adjustment stands, and appellant has not proved it is wrong. In addition, citing Internal Revenue Code (IRC) section 263A and related material, it argues appellant was not entitled to a deduction for rent paid because the law required it to include in inventory costs, expenses incurred to rent the premises where the manufacturing activity occurred.[4]

Appellant has the burden of proving that the federal adjustment is wrong. The copies of the pages from appellant's and the Lantins' 2004 returns do not prove appellant paid rent during 2004. Appellant has provided no evidence that it paid rent to the Lantins and has not explained its failure to provide cancelled checks, bank statements or other evidence of rent payments. A taxpayer must provide credible evidence to meet his or her burden, and a failure to produce evidence that is within the taxpayer's control could give rise to a presumption that such evidence, if provided, would be unfavorable to the taxpayer's case. (*Giddio v. Commissioner of Internal Revenue* (1970) 54 T.C. 1530, 1535; see also *Appeal of Don S. Cookston*, 83-SBE-048, Jan. 3, 1983.) In addition, appellant's unsupported statement that one of the federal auditors allowed the rent deduction is inconsistent with the findings on both audits. The IRS Form 886-A indicates appellant reported no rent paid in 2004 and the second audit, the one before us, determined appellant paid no rent in 2004. The subject audit indicates the IRS allowed no adjustment for rent, and that determination stands. Based on the evidence, we find that appellant is liable for the additional tax based on a federal audit adjustment.[5]

Issue 2 – Whether appellant is liable for the accuracy-related penalty.

Section 19164, which incorporates IRC section 6662, provides for an accuracy-related penalty of 20 percent of the applicable underpayment. As relevant here, the penalty applies to the part of the underpayment attributable to (1) negligence or a disregard of rules and

[4] IRC section 263A applies in California unless otherwise provided. (§ 24422.3.)

[5] We do not address respondent's back-up position that IRC section 263A precludes appellant from deducting the rent expense, because we base our finding on the absence of evidence sufficient to prove that appellant paid rent. Appellant's statement that it paid rent and the pages from the tax returns are not enough. If appellant provided other credible evidence that it paid rent (e.g., a lease for the period at issue and bank documents showing rent payments made by appellant), our finding on this issue might have been different. However, if appellant had provided sufficient evidence of payment, it would need to address FTB's argument based on IRC § 263A.

regulations, or (2) any substantial understatement of income tax. (IRC, § 6662(b).) "Negligence" includes "any failure to make a reasonable attempt to comply" with the IRC. (IRC, § 6662(c).) The term "disregard" is defined to include any "careless, reckless, or intentional disregard." (*Ibid.*) IRC section 6662 provides that, for corporate taxpayers, a substantial understatement of tax exists if the amount of the understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $10,000. (IRC, § 6662(d)(1)(B).)

As previously stated, a deficiency assessment based on a federal audit is presumed correct, and the same presumption applies to penalties. (*Appeal of Davis A. and Barbara L. Beadling* 77-SBE-021, February 3, 1977 [late filing/late payment penalties]; *Appeal of Robert and Bonnie Abney* 82-SBE-104, June 29, 1982 [negligence penalty].) However, the accuracy-related penalty does not apply to any portion of an underpayment if the evidence establishes the taxpayer had reasonable cause for the underpayment and the underpayment resulted from a tax position taken in good faith. (IRC, § 6664(c)(1).)

FTB imposed an accuracy-related penalty because the IRS imposed the penalty. Because the federal understatement did not meet the threshold for substantial understatements, FTB's contention is that the IRS imposed the penalty due to negligence, and it argues that appellant has not overcome the presumption that FTB correctly imposed the penalty.

FTB's contention regarding why the IRS imposed the accuracy-related penalty is not evidence. Neither party has provided evidence regarding the basis for the federal penalty. Appellant has not made an argument or provided any evidence to address the accuracy-related penalty. Instead, it chose to argue only that there was no underpayment. As stated above, appellant has the burden of proving the assessments are wrong. It has failed to rebut the presumption that FTB correctly imposed the penalty. Consequently, we find that appellant is liable for the accuracy-related penalty.

HOLDINGS

1. Appellant is liable for the additional tax and interest based on a federal audit adjustment.
2. Appellant is liable for the accuracy-related penalty.

DISPOSITION

We sustain FTB's action.

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Michael F. Geary
Administrative Law Judge

We concur:

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Teresa A. Stanley
Administrative Law Judge

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Sara A. Hosey
Administrative Law Judge