

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:) OTA Case No. 18010685
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FUKUKO H. OKADA) Date Issued: July 25, 2018
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_____)

OPINION

Representing the Parties:

For Appellant: William R. Jespersen, CPA, CVA
For Respondent: Ronald E. Hofsdal, Tax Counsel IV
For Office of Tax Appeals: William J. Stafford, Tax Counsel III

J. ANGEJA, Administrative Law Judge: Pursuant to Revenue and Taxation Code section 19045,¹ Fukuko Okada (appellant) appeals an action by the Franchise Tax Board (FTB or respondent) on appellant’s protest against a proposed assessment in the amount of \$95,025 in additional tax and an accuracy-related penalty of \$19,005, plus applicable interest, for the 2008 tax year.²

Appellant waived her right to an oral hearing and therefore the matter is being decided based on the written record.

ISSUE

Whether appellant established that the accuracy-related penalty should be abated.

¹ Unless otherwise indicated, all section references are to sections of the California Revenue and Taxation Code.

² On appeal, the FTB has agreed to reduce the additional tax from \$95,025.00 to \$33,972.00. Also, the FTB has agreed to reduce the accuracy-related penalty from \$19,005.00 to \$6,794.40. Appellant is not disputing the additional tax of \$33,972.00. Accordingly, the only issue still in dispute is the accuracy-related penalty of \$6,794.40.

FACTUAL FINDINGS

1. Appellant filed a timely 2008 California Resident Income Tax Return. In her return, appellant failed to indicate that she sold property located along Bird Rock Lane in Pebble Beach, California (Bird Rock property) for \$2,195,000 in the 2008 tax year.
2. FTB reviewed appellant's return and issued a Notice of Proposed Assessment (NPA), setting forth additional tax of \$104,395 and an accuracy-related penalty of \$20,879, plus applicable interest. Appellant filed a timely protest. After reviewing the matter, FTB revised the NPA by issuing a Notice of Action (NOA), which set forth additional tax of \$95,025 and an accuracy-related penalty of \$19,005, plus applicable interest. In response, appellant filed this timely appeal.
3. Appellant purchased the Bird Rock property in 2004 (along with another property not at issue here) as part of a tax-free exchange, pursuant to Internal Revenue Code (IRC) section 1031.
4. Appellant does not have a college degree, and is a self-taught interior designer with no formal training in real estate or tax matters.
5. Appellant timely provided her tax documents and records for the 2008 tax year, including all of the relevant tax documents and information for the sale of the Bird Rock property, to her professional tax preparer, Mr. Joel Knight.
6. Mr. Knight prepared appellant's 2008 returns based on the tax documents and records that appellant provided to him. Based on those documents, Mr. Knight concluded that the sale was a non-taxable IRC section 1031 exchange.
7. Mr. Knight advised appellant that that the sale was a non-taxable IRC section 1031 exchange, and, on that basis, he omitted the sale from appellant's 2008 tax returns.
8. In her November 16, 2016 appeal brief, appellant contends that that she relied upon Mr. Knight's professional advice in signing the returns. Appellant asserts that Mr. Knight is a tax professional with competency in tax law with over 20 years of experience and an expert in real estate and real estate transactions. Appellant adds that she exercised ordinary business care and prudence by hiring Mr. Knight and providing him with all of the relevant facts and documents needed to prepare an accurate tax return.
9. In rebuttal, FTB contends that after selling the property and realizing a gain in 2008, appellant took the position that she had negative income for the 2008 tax year, which the

FTB asserts “is a significant red flag that should have raised concern if the omission of the sale from the tax filings was a true error.”

DISCUSSION

Section 19164, which generally incorporates the provisions of IRC section 6662, provides for an accuracy-related penalty of 20 percent of the applicable underpayment. As relevant here, the penalty applies to the portion of the underpayment attributable to (1) negligence or disregard of rules and regulations, or (2) any substantial understatement of income tax. (IRC § 6662(b).) For an individual, there is a “substantial understatement of income tax” when the amount of the understatement for a taxable year exceeds the greater of ten percent of the tax required to be shown on the return, or \$5,000. (IRC § 6662(d)(1).) In determining whether there is a substantial understatement, the taxpayer excludes any portion of the understatement for which (1) there is substantial authority for the treatment of the position, or (2) the position was adequately disclosed in the tax return (or in a statement attached to the return) and there is a reasonable basis for treatment of the item. (IRC § 6662(d)(2)(B).) To qualify as an adequate disclosure, Treasury Regulations generally require that the taxpayer disclose the details of his or her position on a federal Form 8275, a Form 8275-R, or a qualified amended return. (Treas. Reg. § 1.6662-4(f).) Even if an understatement is found to be substantial, the penalty shall not be imposed to the extent the taxpayer can show reasonable cause and good faith. (Rev. & Tax. Code, § 19164(d); IRC § 6664(c)(1); Cal. Code Regs., tit. 18, § 19164(a).)

A determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis and depends on the pertinent facts and circumstances, including the taxpayer’s efforts to assess the proper tax liability, the taxpayer’s knowledge and experience, and the extent to which the taxpayer relied on the advice of a tax professional. (Treas. Reg. § 1.6664-4(b)(1).) To prove that a taxpayer reasonably relied upon professional advice, the taxpayer must establish by a preponderance of the evidence the following three elements: (1) the advisor was a competent professional who had sufficient expertise to justify reliance; (2) the taxpayer provided necessary and accurate information to the advisor; and (3) the taxpayer actually relied in good faith on the advisor’s judgment. (*Neonatology Associates, P.A. v. Commissioner* (2000) 115 T.C. 43, 91, affd. (3rd Cir. 2002) 299 F.3d 221.)

Here, the undisputed facts are that appellant had no real estate or tax expertise, and she relied upon the advice of a tax professional to whom she provided all relevant information and

documentation. The professional's advice concerned a substantive and complex issue of law (i.e., the tax reporting of sale of a property that had been the subject of an IRC section 1031 exchange), and his advice certainly would have sounded reasonable to a reasonably diligent taxpayer with appellant's education and experience. Under these circumstances, it was reasonable for appellant to rely on the advice of her tax professional, and to hold otherwise would require appellant to have hired an additional professional to obtain a "second opinion," which is unreasonable. As the U.S. Supreme Court has noted,

When an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice because most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require a taxpayer to challenge the authority of the accountant or attorney by seeking a "second opinion" would nullify the very purpose of seeking the advice.

(United States v. Boyle (1985) 469 U.S. 241, 251.)

Additionally, there is no evidence to overcome appellant's assertion that she relied upon Mr. Knight's advice in good faith. As noted above, FTB states that appellant reported "negative income" for the 2008 tax year, which FTB describes as a significant "red flag" that should have raised concern if the omission of the sale from appellant's return was a "true error" (presumably, meaning a reporting mistake made in good faith by Mr. Knight and/or by appellant). We note, however, that the negative income (which is listed on appellant's 2008 return as zero income) was caused, in part, by various deductions and losses that FTB does not dispute. In other words, the reporting of negative income does not establish that appellant knew or should have known that Mr. Knight's advice was erroneous.

Further, we reject FTB's assertion that Mr. Knight never honestly believed that an IRC section 1031 exchange took place because he did not include a federal Form 8824 with appellant's federal return. First, the mere lack of the form does not substantiate the FTB's assertion of dishonesty. Second, and more importantly, FTB's assertion is misplaced because the question is *appellant's* good faith in relying on her tax professional's advice, not her tax professional's good faith in providing it. Appellant has credibly explained that she reasonably and in good faith relied on the advice of Mr. Knight, a tax professional with over 20 years of experience and an expert in real estate transactions. There is no evidence establishing that she knew or should have known that Mr. Knight's advice was erroneous, and therefore we find that

she relied on his advice in good faith.

Based on the foregoing, appellant has established reasonable cause to abate the accuracy-related penalty.

HOLDING

Appellant has established reasonable cause to abate the accuracy-related penalty.

DISPOSITION

Respondent's action is modified, as conceded by FTB on appeal and agreed to by appellant, such that the additional tax set forth in the NOA is reduced from \$95,025 to \$33,972, plus applicable interest. Additionally, in accordance with our holding above, the accuracy-related penalty is abated in full.

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Jeff Angeja
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Jeffrey G. Angeja
Administrative Law Judge

We concur:

DocuSigned by:
Daniel Cho
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Daniel K. Cho
Administrative Law Judge

DocuSigned by:
Nguyen Dang
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Nguyen Dang
Administrative Law Judge