OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:	)	OTA Case No. 18022336
	)	
JOHN A. VERTULLO AND BARBARA J. VERTULLO	)	Date Issued: November 20, 2018
	)	
	)	
	)	

OPINION ON PETITION FOR REHEARING

Representing the Parties:

For Appellants: Denis W. Retoske, Attorney

For Respondent: Richard I. Tay, Tax Counsel III

Office of Tax Appeals: Mai C. Tran, Tax Counsel IV

KWEE, Administrative Law Judge: On December 15, 2017, the State Board of Equalization (board)[1] notified John A. Vertullo and Barbara J. Vertullo (appellants) that it had decided to sustain actions of the Franchise Tax Board (FTB or respondent) in proposing assessments in the following amounts: $326,306.00 in additional tax, an accuracy-related penalty of $65,261.20, plus interest, for 2009; $237,189.00 in additional tax, an accuracy-related penalty of $47,437.80, plus interest, for 2010; and $204,500.00 in additional tax, an accuracy-related penalty of $40,900.00, plus interest, for 2011. Appellants timely petitioned for a rehearing on January 10, 2018, pursuant to RTC section 19048.

ISSUE

Whether appellants established good cause for a new hearing.

[1] Revenue and Taxation Code (RTC) section 20 provides that, unless the context requires otherwise, on and after January 1, 2018, the term "board," with respect to an appeal, means the Office of Tax Appeals. RTC section 40 provides that within 120 days of rendering a decision where the amount in controversy exceeds $500,000, the board is required to publish a written opinion containing six elements. Appellants waived their right to an oral hearing; therefore, this matter was decided on the board's consent calendar. Section 40 does not apply to items placed on the board's consent calendar. OTA does not have a consent calendar and is not specifically subject to section 40, which by its terms applies to "board members" and not administrative law judges. Nevertheless, in the interest of public transparency, this written opinion includes all the elements required by section 40 because the amount in controversy exceeds $500,000.

FINDINGS OF FACT

Pursuant to an undated agreement effective November 1, 2009, appellant-husband renegotiated the terms of a personal loan in the amount of $31,270,861, that was owned by Mr. Ian G. McGown Fisher, a foreign national (hereinafter Lender).[2] The renegotiation did not change the balance due, and thus, no funds were paid to appellant-husband as part of the renegotiation. The source of the $31,270,861 debt was two previously consolidated loans, the terms of which are not contained in the record.[3] The record also does not indicate for what specific purpose appellant-husband borrowed and used the funds from the underlying loans. Further details of this loan transaction (hereinafter Loan) are not relevant to our discussion. During repayment of the Loan, however, in lieu of making cash payments, appellant-husband entered into a complex bond credit arrangement with Lender which appears to have little or no purpose other than to attempt to defer recognition of income for Lender and generate deductions for appellant-husband. The issue on appeal concerns the deductibility of "payments" to Lender pursuant to this bond credit arrangement.

The bond credit arrangement starts with appellant-husband purchasing a bond for the purposes of secretly[4] "selling" the bond to Lender, and subject to appellant-husband "repurchasing" the bond at a later date. In exchange for the secret "sale" of the bond to Lender, Lender credits appellant-husband for interest and fees accruing on the Loan. Later, on the specified date of "repurchase" by appellant-husband, Lender secretly purchases a new bond of greater value from appellant-husband in exchange for returning the old bond, plus interest that accrued on the old bond, to appellant-husband. Appellants, in turn, claim a deduction for the accrued bond interest. Nevertheless, appellants report all interest, including interest accruing during periods of secret "ownership" by Lender, as appellants' own interest income. Appellants

[2] The prior loan was held by a company owned by Lender, whereas the new Loan was directly owned by Lender.

[3] The "payments" at issue in this appeal and which appellant-husband made to Lender following the loan consolidation nevertheless continued to identify and were applied specifically to the underlying pre-consolidation loans (referred to as the "O&G note" and the "Bond note," respectively), as opposed to being made and applied to the consolidation loan. Appellant-husband contends that he has now paid in full one of the two consolidated loans, the Bond note. There is no argument or contention that the second loan, the O&G note, has been paid in full.

[4] We use the legal meaning of the term "secret," referring to something which is kept from the knowledge of others. (See Black's Law Dictionary (10th ed. 2014), secret.) Here, the "sale" was a secret sale because there was no transfer of legal title to Lender to reflect the sale.

claim an investment interest deduction to fully offset this income. In addition to bond interest, appellants also deduct all items credited as "interest" on the Loan as an investment interest expense both at the time Lender purchases a bond from appellant-husband, and at the time Lender resells the bond to appellant-husband for a new bond of greater value. In this manner, Lender receives no cash payments from appellant-husband on the Loan, and no bond interest income is reported under his taxpayer identification number because the sale did not involve a transfer of legal title.

In summary, appellants claimed a tax deduction for the "credits" against interest accruing on the Loan, and interest accruing on the bonds, both as an "investment" interest expense of appellant. Appellants contend they legally sheltered $7,969,244 of income in this manner during the three tax years at issue and, thus, have $0 in taxable income for these years. Appellants believe all such credits constitute deductible payments of interest, and that the underlying indebtedness is on property held for investment. The record does not indicate on what theory appellants believe the $31,270,861 Loan constitutes indebtedness on property held for investment.

In the first documented[5] transaction related to the bond credit arrangement, dated December 31, 2009, appellant-husband and Lender entered into an agreement that included all the following steps. First, appellant-husband purchased a General Motors Acceptance Corp. Bond (GM Bond), with a face value of $4,800,000, plus $47,743 in accrued interest, on November 2, 2009, for $4,847,748.31 (inclusive of a trade processing fee). Second, appellant-husband "sold" a 95.49 percent interest in the GM Bond to Lender for $4,629,451 on December 31, 2009. The $4,629,451[6] that Lender "paid" for the GM Bond came from the following sources: (1) crediting appellant-husband's Loan balance due by $2,684,038 ($2,530,218 allocated to interest and $153,820 to principal); (2) crediting appellant-husband's Loan balance

[5] It is clear from the documentation that this is not the first transaction related to the bond credit arrangement. It is also clear that appellants failed to document all of the related transactions because additional bonds are referenced in the available documents, but are not otherwise documented or explained. At a minimum, appellants did not provide documentation on the prior related transaction(s) which would have involved the "sale" and commitment to "repurchase" the Reynolds Bond, or the subsequent repurchase transaction(s) for the Bell Bond, Steel Bond, or Genworth Bond, described below. For example, appellants provided documentation that appellant-husband "sold" the Bell Bond, and that he was required to repurchase the Bell Bond, but failed to document the "repurchase" transaction.

[6] The amount of credits exceeds the purchase price by $3,149. This is an error in the agreement, and not in our opinion. Appellants deducted the $3,149 in the amount of investment interest expense claimed for 2009.

by an additional $810,000 (all allocated to interest); (3) "reselling" an undocumented bond identified only as the "Reynolds Bond"[7] to appellant-husband for a stated Lender credit of $1,135,413 to purchase the GM Bond; and (4) exchanging the $3,149 in interest that accrued in Lender's favor on the Reynolds Bond for a $3,149 Lender credit to purchase the GM Bond. Third, appellant-husband agreed to "repurchase" the GM Bond for $4,629,451 at a later date. Fourth, the GM Bond and interest paid to appellant-husband on the GM Bond were required to be held by appellant-husband for the benefit of Lender.

The parties entered into a second related transaction on March 17, 2010, which included the following steps. First, on March 16, 2010, appellant-husband purchased a Corporate Bond of Cincinnati Bell, Inc. (Bell Bond), with a face value of $5,037,500, plus $4,861 in accrued interest, for $5,042,366.36 (inclusive of a trade processing fee). Second, on March 17, 2010, appellant-husband "sold" a 93.13 percent interest in the Bell Bond to Lender for $4,695,803. The $4,695,803 that Lender "paid" to appellant-husband came from the following sources: (1) "reselling" the GM Bond to appellant-husband for a stated credit of $4,629,451 to the Loan balance; and (2) exchanging the $66,352 in interest on the GM Bond that accrued in Lender's favor for a $66,352 Lender credit to purchase the Bell Bond. Third, appellant-husband agreed to "repurchase" the Bell Bond for $4,695,803 at a later date.[8] Fourth, the Bell Bond and interest paid to appellant-husband on the Bell Bond were to be held by appellant-husband and credited to the benefit of Lender.

The parties entered into a third related transaction on December 31, 2010, which included the following steps. First, on August 4, 2010, appellant-husband purchased a U.S. Steel Corporation Bond (Steel Bond), with a face value of $3,011,250, plus $4,666.67 in accrued interest, for $3,015,916.67 (inclusive of a trade processing fee). Second, on December 31, 2010, appellant-husband "sold" an 80.23 percent interest in the Steel Bond to Lender for $2,419,525. The $2,419,525 that Lender "paid" to appellant-husband came from the following sources: (1) crediting appellant-husband's Loan balance in the amount of $1,271,432, applied to interest; (2) crediting appellant-husband's Loan balance by an additional $810,000, applied to interest; and

[7] The record contains no additional information on the details surrounding the Reynolds Bond, such as the agreement whereby appellant-husband "sold" the Reynolds Bond to Lender.

[8] The record contains no additional information on the details surrounding the Bell Bond, such as the agreement whereby appellant-husband "repurchased" it from Lender.

(3) crediting an additional $338,093 to a mandatory fee due on the Loan.[9] Third, appellant-husband agreed to "repurchase" the Steel Bond for $2,419,525 at a later date.[10] Fourth, the Steel Bond and interest paid to appellant-husband on the Steel Bond were required to be held by appellant-husband and credited to the benefit of Lender.

The parties entered into a fourth related transaction on December 31, 2011, which included the following steps. First, on March 25, 2011, appellant-husband purchased a Genworth Financial, Inc., Corporate Bond (Genworth Bond), with a face value of $3,052,500, plus $3,177 in accrued interest, for $3,055,677.08 (inclusive of a trade processing fee). Second, on December 31, 2011, appellant-husband "sold" an 81.81 percent interest in the Genworth Bond to Lender for $2,500,000. The $2,500,000 that Lender "paid" to appellant-husband came from the following sources: (1) crediting appellant-husband's Loan balance by $1,330,000, applied to interest; and (2) crediting appellant-husband's Loan balance by an additional $1,170,000, applied to interest. Third, appellant-husband agreed to "repurchase" the Genworth Bond for $2,500,000 at a later date.[11] Fourth, the Genworth Bond and interest paid to appellant-husband on the Genworth Bond were required to be held by appellant-husband and credited to the benefit of Lender.

In connection with the above agreements, appellants reported all the interest from the bonds (including interest accruing on the bonds "sold" to Lender) as appellant-husband's interest income for tax purposes. Appellant-husband held legal title to all the bonds in a Morgan Stanley Smith Barney LLC, Brokerage Account (Brokerage Account) owned by appellant-husband. The interest income for all the bonds were reported to the Internal Revenue Service (IRS) as appellant-husband's income on Forms 1099-INT. Furthermore, appellants claimed an investment interest deduction for the interest "payments" that appellant-husband "sold" to Lender (pursuant to the second step, described in the transactions above).[12] Appellants also

[9] As relevant, this mandatory loan fee is not specifically provided for in the Loan, based on the information provided by appellants.

[10] The record contains no additional information on the details surrounding the Steel Bond, such as the agreement whereby appellant-husband "repurchased" it from Lender.

[11] The record contains no additional information on the details surrounding the Genworth Bond, such as the agreement whereby appellant-husband "repurchased" it from Lender.

[12] In other words, appellants consider the secret purported "sale" of each bond to Lender to constitute a "payment" of interest on the Loan. Appellants consider each "payment" on the Loan to be an investment interest expense on the unsubstantiated basis that Loan constitutes indebtedness on property held for investment.

deducted bond interest accruing on the bonds that were "sold" to Lender at the time the bonds were returned, as a Lender credit, to appellant-husband (i.e., the interest reported on Forms 1099-INT). Appellants claimed the investment interest deduction on line 14 (investment interest) of Schedule A (itemized deductions) of their federal tax returns, and made no adjustments to these amounts on their state tax returns.[13]

By Notices of Proposed Assessment dated April 8, 2014, FTB disallowed the claimed investment interest deductions. Appellants protested the proposed assessments, which FTB denied by Notices of Action dated July 9, 2015. Appellants timely appealed to the board on August 10, 2015. The board adopted a 30-page non-precedential summary decision denying the appeal on December 11, 2017. On the first issue, the board concluded that appellants' representations that appellant-husband credited payments to Lender as book entries were insufficient to prove actual payment or entitlement to an investment interest deduction. On the second issue, the board concluded that appellants did not provide evidence or argument to show that they acted reasonably and in good faith, or establish any other basis for abatement of the accuracy-related penalty. The board notified appellants that it denied their appeal on December 15, 2017. This timely petition for rehearing followed.

DISCUSSION

In sustaining FTB's actions, the board determined that: (1) appellants failed to establish that they were entitled to deduct claimed investment interest for the 2009, 2010, and 2011 tax years; and (2) appellants failed to establish a basis for abatement of the accuracy-related penalty. Appellants dispute both of these determinations and contend that their petition should be granted because there is insufficient evidence to justify the board's decision or the board's decision is against law. (Cal. Code Regs., tit. 18, § 30602(c)(5)(D).)

A petition for rehearing must contain all the facts and legal authorities necessary to either: (1) identify an irregularity in the proceedings that prevented the fair consideration of the appeal; (2) identify an accident or surprise that occurred, which ordinary caution could not have prevented; (3) identify newly discovered, relevant evidence, which the filing party could not have reasonably discovered and provided prior to the decision; (4) demonstrate there was insufficient evidence to justify the decision or the decision is contrary to law; (5) identify an

[13] The returns were prepared by Mr. Denis Retoske, who represents appellants in the instant appeal.

error in law that occurred during the proceedings. (Cal. Code Regs., tit. 18, § 30602(c)(5); *Appeal of Sjofinar Masri Do*, 2018-OTA-002P, Mar. 22, 2018; *Appeal of Wilson Development, Inc*., 94-SBE-007, Oct. 5, 1994.)[14] Further, as provided in *Appeal of Wilson Development, Inc., supra*, good cause for granting a new hearing may be shown where one of the above-identified grounds exists and the rights of the complaining party are materially affected. (See also *Appeal of Sjofinar Masri Do, supra*.)

At the trial court level, the equivalent of a petition for rehearing is a motion for a new trial. Code of Civil Procedure section 657 sets forth the grounds for granting a new trial. As explained in the board's precedential decision in the *Appeal of Wilson Development, supra*, and as reflected in the board's Rules for Tax Appeals, the board has historically looked to the Code of Civil Procedure, section 657, in determining whether grounds for a rehearing exist. (See, e.g., Cal. Code Regs, tit. 18, § 5461(c)(5).) OTA intends to continue the board's established precedent of looking to Code of Civil Procedure section 657, and the applicable caselaw, in determining whether to grant a new hearing. (See Cal. Code Regs., tit. 18, § 30602(c)(5); see also *Appeal of Sjofinar Masri Do, supra*.)

Code of Civil Procedure section 657 codifies well-established caselaw with respect to the sufficiency of the evidence standard of review. (See *Harper v. Superior Air Parts, Inc*. (1954) 124 Cal.App.2d 91; *Reilley v. McIntire* (1938) 29 Cal.App.2d 559.) A rehearing should not be granted on the grounds of insufficiency of the evidence unless, after weighing the evidence, we are convinced from the entire record, including reasonable inferences therefrom, that a different decision should have been reached. (Code Civ. Proc., § 657.)

The question of whether a decision is contrary to law is not one that involves a weighing of the evidence, but instead requires a finding that the decision is "unsupported by any substantial evidence." (*Sanchez-Corea v. Bank of America* (1985) 38 Cal.3d 892, 906.) The relevant question is not over the quality or nature of the reasoning behind the decision, but whether the decision can or cannot be valid according to the law. (*Appeal of Nassco Holdings, Inc*., 2010-SBE-001, Nov. 17, 2010.) The fact that a person is dissatisfied with the outcome of the appeal is not grounds for a rehearing.

[14] Precedential opinions of the board that were adopted prior to January 1, 2018, may be cited as precedential authority to the Office of Tax Appeals unless a panel removes, in whole or in part, the precedential status of the opinion. (Cal. Code Regs, tit. 18, § 30501(d)(3).) The board's precedential opinions are viewable on their website: <http://www.boe.ca.gov/legal/legalopcont.htm>.

I. Disallowed Investment Interest Deduction

Gross income means all income from whatever source derived, including interest income. (RTC, § 17071; Int.Rev. Code (IRC),[15] § 61(a)(4).) A deduction is generally allowable for all interest paid during the tax year; however, no deduction is allowable for personal interest. (RTC, § 17201; IRC, § 163(a), (h).) As relevant to this appeal, "personal interest" means all interest other than interest paid on indebtedness from a trade or business, investment interest, and qualified residence interest. (RTC, § 17201; IRC, § 163(h)(2).) "Investment interest" means any interest which is paid on indebtedness properly allocable to property held for investment. (RTC, § 17201; IRC, § 163(d)(3)(A).) A deduction for investment interest is limited to the amount of investment income for the taxable year. (RTC, § 17201; IRC, § 163(d)(1).)

The taxpayer bears the burden of establishing entitlement to any deductions claimed. (*Appeal of Gilbert W. Janke*, 80-SBE-059, May 21, 1980; *Appeal of J. Walshe and M. Walshe*, 75-SBE-073, Oct. 20, 1975.) To support a deduction, the taxpayer must establish by credible evidence, other than mere assertions, that the deduction claimed falls within the scope of a statute authorizing the deduction. (*New Colonial Ice Co., Inc. v. Helvering* (1934) 292 U.S. 435, 440; *Appeal of Robert R. Telles*, 86-SBE-061, Mar. 4, 1986; *Appeal of A. Magidow and E. Magidow*, 82-SBE-274, Nov. 17, 1982.) Additionally, an FTB determination is presumed correct and, therefore, a taxpayer has the burden of proving such determination erroneous. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of George H. and Sky Williams, et al*., 82-SBE-018, Jan. 5, 1982.)

The amount claimed as a deduction by a cash basis taxpayer must have been "paid" to be deductible, and the parties' evidence and arguments primarily centered on this threshold requirement.[16] (*Helvering v. Price* (1940) 309 U.S. 409, 413; *Wilkerson v. Commissioner* (1981) 655 F.2d 980, 982.) Evidence shows that even though appellant-husband "sold" the bonds to Lender (which appellants contend also constitutes a "payment" of interest), appellant-husband nevertheless retained legal title to the bonds under appellant-husband's own Brokerage Account. Consistent with maintaining legal ownership of the bonds, both appellant-husband and his Brokerage Account reported to the IRS that the interest income generated by the bonds belonged

[15] The Internal Revenue Code (IRC) is found under Title 26 of the United States Code.

[16] The board's summary decision addressed the parties' contentions on the issue of payment and evidence of payment in great detail, and concluded that the arrangement did not result in "payment" of investment interest.

to him for the periods that appellants contend the bonds were owned by Lender. This fact is inconsistent with "selling" the bonds to Lender. Later, these same bonds were required to be "resold" to appellant-husband. Thus, the evidence shows that the claimed "payments" (i.e., the bonds) were never legally transferred to Lender, and were never in the possession and control of Lender. Appellants also concede the Loan is a personal promissory note, and there is no argument, or evidence in the record sufficient to support a finding, that the Loan qualifies as indebtedness on property held for investment, which is an additional legal requirement to claim the deduction. Thus, based on the evidence in the record, appellants failed to establish entitlement to claim an investment interest deduction.

Further, it is clear from the available evidence, which references additional bonds and additional "repurchases" of the bonds for which no information is contained in the record, that appellants failed to fully document key information about the transactions surrounding the purported "payment" of interest that generated the claimed investment interest deduction. Such documentation would be necessary to fully understand the entirety of the transaction, including whether, and when, any payment(s) were made on the Loan and whether any such payments are deductible.[17] Therefore, we find sufficient evidence to justify the board's determination that appellants failed to establish entitlement to the claimed investment interest deduction, and that the board's decision was not contrary to law.

II. Accuracy-Related Penalties

The law imposes a 20-percent accuracy-related penalty on any underpayment attributable to, among other things, a substantial understatement of income tax. (RTC, § 19164(a)(1)(A); IRC, § 6662(b)(2).) For noncorporate taxpayers, an understatement is substantial if it exceeds the greater of $5,000 or 10 percent of the tax required to be shown on the return. (IRC, § 6662(d)(1)(A).) Nevertheless, the accuracy-related penalty is reduced to the extent that any portion of the understatement is attributable to an item for which the taxpayer had or has

[17] Thus, for example, given the lack of documentation, there is no evidence in the record to show what, if anything, was ultimately transferred to and retained by Lender to conclude the bond credit arrangement, and for what purposes the underlying funds from the two consolidated loans were used. Instead, appellants only documented the middle transactions, and failed to document beginning and ending transactions to the bond credit arrangement. Appellants contend one of the two consolidated loans was paid off in 2013, in exchange for the transfer of real property. Payment status on the second of the two consolidated loans is unknown.

substantial authority for its treatment of that item.[18] (IRC, § 6662(d)(2)(B)(i).) The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. (Treas. Reg. § 1.6662-4(d)(2).) The taxpayer must have substantial authority, both under the facts and the law, to support the taxpayer's treatment of the item in dispute. (*Estate of Kluener v. Commissioner* (6th Cir. 1998) 154 F.3d 630, 638.) The accuracy-related penalty also does not apply to any portion of an underpayment if the taxpayer establishes that there was reasonable cause for the underpayment and the taxpayer acted in good faith with respect to the underpayment. (IRC, § 6664(c)(1).

In their petition for rehearing, appellants first raise arguments for why the accuracy-related penalties for 2009, 2010, and 2011 should be abated. In support, appellants contend that they offered legal justification for their position on the investment interest expense deduction during their appeal before the board, and that appellants' belief that their position is legally justified is itself a basis for abatement of the accuracy-related penalty. Here, our standard of review is not what evidence or arguments appellants submit in a petition for rehearing. Instead, our review focuses on whether there was sufficient evidence in the record to justify the decision, or whether (based on such evidence in the record) the decision cannot be valid under the law. The available evidence establishes that the understatement of tax ($326,306 for 2009, $237,189 for 2010, and $204,500 for 2011) was substantial because the understatement represented 100 percent of the tax required to be shown on the returns.[19]

Appellants had the burden of proving any defenses to imposition of the accuracy-related penalty. (*Recovery Group, Inc. v. Commissioner*, T.C. Memo. 2010-76.) As stated in the board's decision in this matter, during the appeal before the board, appellants made no specific argument and presented no evidence to rebut imposition of the accuracy-related penalties. Here, the available evidence is incomplete, missing key documents, and insufficient to support a finding that payments were actually made. Furthermore, the evidence available is insufficient to support a finding that, even if interest payments were actually made, the underlying Loan even qualifies as indebtedness on property held for investment. Considering the available evidence in

[18] The penalty also will not apply to any portion of an understatement for which the taxpayer had a reasonable basis for the tax treatment of an item, provided that the taxpayer made an adequate disclosure of the relevant facts affecting the item's tax treatment on their return or on a statement attached to the return. (IRC, § 6662(d)(2)(B)(ii).) We do not discuss this provision because appellants made no such disclosure.

[19] In other words, appellants reported $0 in tax liability for all three years.

the record regarding the claimed investment interest deduction, we are unable to find a basis to reasonably infer that appellants acted in good faith or had substantial authority with respect to the underpayment. Therefore, we find that there was sufficient evidence to justify the board's decision that appellants failed to establish a defense to imposition of the accuracy-related penalty, and that the board's decision was not contrary to the law.

DISPOSITION

Appellants failed to establish good cause for a new hearing. Therefore, the petition for a rehearing is denied.

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Andrew J. Kwee
Administrative Law Judge

We concur:

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Kenneth Gast
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Kenneth Gast
Administrative Law Judge

DocuSigned by:
Jeffrey I. Margolis
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Jeffrey I. Margolis
Administrative Law Judge