

**OFFICE OF TAX APPEALS
STATE OF CALIFORNIA**

In the Matter of the Appeal of:) OTA Case No. 18011122
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DERMATOLOGY MANAGEMENT, LLC) Date Issued: November 27, 2018
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OPINION

Representing the Parties:

For Appellant: Ken Sturm, Representative

For Respondent: Maria Brosterhous, Tax Counsel IV

For Office of Tax Appeals: Joshua Lambert, Tax Counsel

MARGOLIS, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19324,¹ Dermatology Management, LLC (appellant) appeals actions by the Franchise Tax Board (FTB or respondent) in denying appellant’s claims for refund in the amounts of: \$1,932 for the tax year ending (TYE) May 1, 2014, consisting of a \$432 partnership late-filing penalty under section 19172 and a \$1,500 late-filing penalty under section 19131; \$4,126.50 for TYE October 31, 2014, consisting of a \$2,947.50 late-filing penalty under section 19131 and a \$1,179 penalty for failing to timely pay an estimated LLC fee under section 17942; and \$518 for TYE December 31, 2014, consisting of a late payment penalty under section 19132. This matter is being decided based on the written record because appellant waived its right to an oral hearing.

ISSUES

Whether appellant established a basis for abatement of the: (1) section 19172 partnership late-filing penalty; (2) section 19131 late-filing penalty; (3) section 17942(d)(2) penalty for underpayment of the estimated LLC fee; or (4) section 19132 late payment penalty.

¹ Unless otherwise indicated, all section references are to the R&TC.

FACTUAL FINDINGS

1. Appellant is a limited liability company (LLC) doing business in California. Appellant is registered with the California Secretary of State.
2. Due to multiple ownership changes during calendar year 2014, appellant determined, in September 2015, that it was required to file tax returns for three separate short reporting periods occurring during 2014: first, January 1 through May 1, 2014 (TYE 5/1/14); second, May 2 through October 31, 2014 (TYE 10/31/14); and third, November 1 through December 31, 2014 (TYE 12/31/14).
3. During the first reporting period (TYE 5/1/14), appellant had two LLC members and was treated as a partnership for tax purposes. During the two remaining reporting periods (TYE 10/31/14 and TYE 12/31/14), appellant had a single LLC member,² and was a disregarded entity for California tax purposes.
4. On September 15, 2015, appellant simultaneously filed three separate LLC Returns of Income (California Forms 568), one for each of the reporting periods at issue. The tax returns for the first two reporting periods (TYE 5/1/14 and TYE 10/31/14) were untimely, and the return for the third reporting period (TYE 12/31/14) was timely (after taking into account the automatic extension of section 18567(a)). Summarized below, in chronological order, are the three returns.
5. Appellant's return for the first reporting period (TYE 5/1/14) reported that appellant was subject to the \$800 annual minimum LLC tax (imposed under section 17941), plus an LLC fee of \$6,000 (imposed under section 17942), for a total of \$6,800. After applying payments totaling \$12,590,³ appellant reported a \$5,790 overpayment. Appellant requested that the overpayment be applied to its subsequent reporting period's tax or fee obligation.
6. Appellant's return for the second reporting period (TYE 10/31/14) reported that appellant was subject to the \$800 annual minimum LLC tax, plus an LLC fee of \$11,790, for a total

² The identity of the single LLC member differed for each of those periods.

³ The record does not reveal exactly when the taxpayer made these payments. However, FTB did not assess either a section 19132 late payment penalty or a section 19131 late-filing penalty with respect to the \$800 LLC tax for the first reporting period. Additionally, FTB did not assess a penalty for underpayment of the estimated LLC fee with respect to appellant's first reporting period. Therefore, we find that the \$800 LLC tax was timely paid on or before April 15, 2014 (see R&TC, § 17941(c)), and the LLC fee for the first reporting period was timely paid on or before June 15, 2014 (see R&TC, § 17942(d)(1)).

of \$12,590. After claiming a credit for the \$5,790 overpayment from TYE 5/1/14, appellant reported \$6,800 in tax due.

7. Appellant's return for the third reporting period (TYE 12/31/14) reported that it was subject to the \$800 annual minimum LLC tax, plus an LLC fee of \$6,000, for a total amount due of \$6,800.
8. For the first reporting period (TYE 5/1/14), FTB assessed a late-filing penalty of \$1,500 under section 19131,⁴ and a partnership late-filing penalty of \$432 under section 19172.⁵
9. For the second reporting period (TYE 10/31/14), FTB assessed a late-filing penalty of \$2,947.50 under section 19131⁶ and a 10-percent underpayment of estimated LLC fee penalty of \$1,179.⁷
10. For the third reporting period (TYE 12/31/14), FTB assessed a \$518 late payment penalty.⁸
11. On September 15, 2015, appellant paid the balance of the tax, penalties, and interest that remained due for the three reporting periods at issue.
12. On August 22, 2016, appellant filed a separate Reasonable Cause – Business Entity Claim for Refund for each reporting period. Each claim asks for a refund of all penalties assessed on the basis that, due to appellant's ownership changes and internal restructuring during 2014, appellant was uncertain as to "the correct short period tax year ends and due dates." Appellant further contends that it relied on "tax and accounting professionals to provide input as to the due dates for all tax payments [and] filings," and that it promptly paid the tax liabilities as soon as it became aware of its obligations.⁹

⁴This amount represents 25 percent of the \$6,000 LLC fee. FTB asserts in its brief that the section 19131 late-filing penalty only applies to the LLC fee, and not to the \$800 LLC tax.

⁵This amount represents \$18, multiplied by the number of reported members (two), multiplied by the number of months late the return was filed as calculated from the original due date, not to exceed 12 (i.e., 12 months, covering the period September 15, 2014, through September 15, 2015).

⁶This amount represents 25 percent of the \$11,790 LLC fee.

⁷This amount represents 10 percent of the \$11,790 LLC fee.

⁸This amount is the sum of the following: (1) \$6,800, multiplied by five percent; (2) \$6,000 multiplied by .5 percent, multiplied by the number of months late the LLC fee was paid (i.e., 5 months, from April 15, 2015, until September 15, 2015); and (3) \$800 multiplied by .5 percent, multiplied by the number of months late the annual minimum tax was paid (i.e., 7 months, from February 15, 2015, until September 15, 2015).

⁹ Appellant self-assessed the underlying taxes and LLC fees and they are not at issue in this appeal.

13. On September 6, 2016, FTB issued a separate Notice of Action (NOA) for each reporting period. Each NOA denied appellant's claim for refund on the basis that appellant failed to establish reasonable cause.
14. On December 5, 2016, appellant timely filed the instant appeal, restating the contentions raised in its claims for refund, and explaining that appellant changed its tax preparer and internal accounting department due to a restructuring in 2014, resulting in uncertainty as to the tax years and due dates.
15. On April 7, 2017, FTB filed its opening brief. In it, FTB concedes that it failed to apply appellant's \$5,790 overpayment from the first reporting period (TYE 5/1/14) in calculating the amount of penalties due for the second reporting period (TYE 10/31/14). FTB's concession reduces the late-filing penalty for the second reporting period from \$2,947.50 to \$1,500 (25 percent of the \$6,000 LLC fee reported due with the return), and the 10-percent underpayment of estimated LLC fee penalty from \$1,179 to \$600 (10 percent of the underpaid LLC fee amount). In all other respects, the FTB asks that its action be sustained.

DISCUSSION

The partnership late-filing penalty under section 19172

California imposes a per-partner late-filing penalty on a partnership that fails to file its return on or before the due date, unless the late filing is shown to be due to "reasonable cause." (R&TC, § 19172(a).) The amount of this penalty is the product of two multiplication factors. (R&TC, § 19172(b).) They are: (1) eighteen dollars; and (2) the number of partners in the partnership during any part of the taxable year. (R&TC, § 19172(b).) The penalty is added monthly, for each month, or fraction of a month, not to exceed 12 months, during which the partnership's failure to file a required return continues. (R&TC, § 19172(a).) This penalty also applies to LLCs that are treated as partnerships for tax purposes.¹⁰ (R&TC, § 19172(a) [incorporating section 18633.5, which specifies the return-filing obligations of LLCs classified as partnerships].)

¹⁰ FTB only imposed this penalty for the first reporting period because that was the only reporting period during which appellant was treated as a partnership for tax purposes. During the second and third reporting periods, appellant was a single-member LLC that was not taxed as a partnership.

For tax reporting periods ending in 2014, LLCs taxable as partnerships were required to file a return on or before the fifteenth day of the fourth month following the close of the tax reporting period. (R&TC, § 18633.5(a).)¹¹ FTB Form 568 (Limited Liability Company Return of Income) is the return used by such entities to report items of gross income and deductions.¹² (See R&TC, § 18633.5(a).)

Thus, if appellant had been required to report on a calendar year basis for 2014, its Form 568 return would have been due on April 15, 2015. Pursuant to California's automatic extension provisions, however, appellant could have timely filed a full-year return for 2014 at any time on or before October 15, 2015.¹³ Appellant ultimately filed all three of its returns for the short reporting periods beginning and ending during calendar year 2014 by that date.

However, for the first two short reporting periods (i.e., for TYEs ending 5/1/14 and 10/31/14), appellant determined it was required to accelerate the date by which it filed its returns. FTB imposed the late-filing penalties that are at issue in this appeal because appellant did not meet these accelerated filing deadlines.

FTB determined that a \$432 partnership late-filing penalty was due for the first reporting period (TYE 5/1/14) pursuant to section 19172 because appellant's return for that period was due on September 15, 2014, but appellant did not file it until 12 months later, on September 15, 2015. FTB contends that in order to abate a late-filing penalty under section 19172, the taxpayer must establish both reasonable cause and lack of willful neglect. Although the section 19172 per-partner late-filing penalty does require establishing reasonable cause for the late filing in order to abate the penalty, it does not require an absence of willful neglect.¹⁴

For a taxpayer to establish that a failure to file was due to reasonable cause, the taxpayer must show that the failure occurred despite the exercise of ordinary business care and prudence,

¹¹ Section 18633.5 was amended, effective January 1, 2017, by Assembly Bill 1775 (Stats. 2016, ch. 348) to shorten this due date by a month.

¹² See page three of FTB's 2014 Limited Liability Company Tax Booklet, <https://www.ftb.ca.gov/forms/2014/14_568bk.pdf> (accessed 10/29/2018).

¹³ California law provides for an automatic six-month extension of time to file; however, an extension is not allowed if the return is not filed within the extension period. (R&TC, § 18567(a); Cal. Code Regs., tit. 18, § 18567(a).) Section 18567 was amended by Assembly Bill 119 (Stats. 2017, ch. 21) to allow for extensions of up to seven months for certain partnerships filing returns for reporting periods beginning on or after January 1, 2017.

¹⁴ In this regard, section 19172 is worded differently than the general late-filing penalty of section 19131, which by its terms requires establishing the absence of "willful neglect" (in addition to a showing of "reasonable cause") before the section 19131 late-filing penalty may be abated.

and that cause existed as would prompt an ordinarily intelligent and prudent businessperson to have so acted under similar circumstances. (*United States v. Boyle* (1985) 469 U.S. 241, 245-246 (*Boyle*); *Appeal of Roger W. Sleight*, 83-SBE-244, Oct. 26, 1983; *Appeal of M.B. and G.M. Scott*, 82-SBE-249, Oct. 14, 1982.)¹⁵ Respondent contends that appellant has not met this standard. We disagree.

Appellant's tax filing obligations for calendar year 2014 would have been timely fulfilled had appellant reported on the annual calendar year basis that normally applies for income and franchise tax purposes, because appellant's September 15, 2015, filing date was within the automatic extension period.¹⁶ It was only after the end of the calendar year, when appellant – like most taxpayers – commenced determining its tax liability for the year, that appellant determined that it was required to break up its 2014 tax year into three separate short-year reporting periods and file separate returns for each period.

When appellant realized, after the close of the calendar year, that due to transfers of its LLC member interests, it was liable for not one, but three separate returns for a single calendar year, and owed three “annual” LLC tax amounts and three “annual” LLC fees, it filed all three returns and paid LLC taxes and fees for each reporting period. And it did so within the time period that would have applied had it been a calendar year taxpayer. There is no allegation nor evidence of bad faith or dilatory conduct on appellant's part.

Given these unique circumstances, we find that reasonable cause exists for appellant's late filings. Appellant acted reasonably in analyzing its tax position after the close of its calendar year, consistent with the normally applicable schedule for filing its tax returns. The U.S. Supreme Court's decision in *Boyle* does not compel a different result. Under *Boyle*, the duty to timely file a return is imposed on the taxpayer; therefore, delegating this duty to a tax professional and thereafter assuming that the tax professional will or did file the return fails to satisfy the reasonable cause standard of ordinary business care and prudence. (*Boyle, supra*, at p. 250.) This conclusion was based, in principal part, upon a factual scenario where the taxpayer's

¹⁵ The board's precedential opinions (designated by “SBE” in its citation) are viewable on the board's website at <<http://www.boe.ca.gov/legal/legalopcont.htm>>.

¹⁶ Appellant's payment obligations also appear to have been fully and timely satisfied had it been taxable on a calendar year basis. The facts indicate that appellant had fully paid the \$800 “annual” LLC tax for the first reporting period on or before April 15, 2014, and had paid an additional \$11,790 “annual” LLC fee (the maximum fee amount) on or before June 15, 2014.

obligation to file a return, and the applicable filing deadline, were clear and unambiguous. (*Boyle, supra*, at p. 245.) By way of contrast, in the situation here, appellant’s obligation to file three different returns and pay three separate “annual” LLC tax amounts and “annual” LLC fees is not at all clear.¹⁷ Most taxpayers file returns and pay their franchise and income taxes on an annual basis, not three times a year. In the situation presented, we find that appellant has established reasonable cause for the late-filings. Therefore, we abate the section 19172 late-filing penalty.

The general late-filing penalty under section 19131

Section 19131 imposes a penalty for failing to file a return on or before the due date, unless it is shown that the failure to timely file was due to reasonable cause and not willful neglect.¹⁸ (R&TC, § 19131(a).) The amount of the late-filing penalty imposed by section 19131 is five percent of the tax due, after allowing for timely payments, for every month or fraction of a month that the return is late, up to a maximum penalty of 25 percent.¹⁹ (R&TC, § 19131(a).) This “general” late-filing penalty is separate and distinct from the per-partner late-filing penalty imposed under section 19172, and a partnership (or LLC taxed as a partnership) may be subject to both penalties for the same reporting period.²⁰

FTB asserts that this penalty applies at the maximum rate of 25 percent for both the first reporting period (because the return for TYE 5/1/14 was filed 12 months late) and the second reporting period (because the return for TYE 10/31/14 was filed more than 5 months late), and FTB’s calculations are not disputed. We explained above (in connection with the per-partner late-filing penalty) the basis for our finding that appellant’s late-filings were due to reasonable

¹⁷ Appellant’s obligation to file three tax returns, pay three “annual” LLC tax amounts, and pay three LLC “annual” fee amounts for three short reporting periods within a single calendar year is not something FTB has provided clear guidance upon. In this regard, we note that FTB’s Form 568 Limited Liability Company Booklet for 2014, under “Accounting Periods,” states that “LLC returns normally must be filed for an accounting period that includes 12 full months,” and that “[a] short period return must be filed if the LLC is created or terminated within the taxable year.” (FTB’s 2014 LLC Tax Booklet, <https://www.ftb.ca.gov/forms/2014/14_568bk.pdf> at p. 9 [accessed 10/29/2018].)

¹⁸ The standard of willful neglect means a conscious, intentional failure or reckless indifference. (*Boyle, supra*, at p. 245.)

¹⁹ As noted in footnote 4, FTB only calculated the section 19131 penalties against appellant based on the late-paid LLC fees, and not the LLC tax amounts. The calculation of the amount of the section 19131 penalties is not at issue in this appeal.

²⁰ FTB assessed both such penalties for the first reporting period (TYE 5/30/14).

cause. Furthermore, we find that, taking into consideration the unique facts of this case, the late-filing was not the result of willful neglect, and that appellant's tax filings would have been timely under the usual calendar-year reporting method. Therefore, we abate the late-filing penalties assessed under section 19131.

The underpayment of estimated LLC fee penalty under section 17942(d)(2))

Section 17942 imposes an LLC fee based on total California source income of LLCs that are doing business in California. The LLC fee is required to be estimated and paid on or before the 15th day of the sixth month of the taxable year. (R&TC, § 17942(d)(1).) When the estimated payment of the LLC fee is less than the amount of LLC fee due for the taxable year, a penalty equal to 10 percent of the underpayment is imposed unless the fee amount that was timely estimated and paid was equal to or greater than the total amount of the LLC fee assessed for the preceding taxable year. (R&TC, § 17941(d)(2).) The statute does not provide for a reasonable cause defense to imposition of the penalty.

Here, FTB assessed an underpayment of estimated LLC fee penalty for the second reporting period (TYE 10/31/14) because the LLC fee for that period was required to be estimated and paid by October 15, 2014 (i.e., the 15th day of the sixth month of that six-month reporting period), but appellant did not pay it until September 15, 2015. The underpaid amount was \$6,000.²¹ Appellant raises a reasonable cause defense to imposition of the penalty by asserting that it relied on a tax professional to ascertain the payment and return due dates. Nevertheless, the only defense to the penalty authorized by statute is the safe harbor provision which provides that the penalty will not be imposed if the estimated LLC fee payment is equal to or exceeds the LLC fee assessed in the prior tax year. Here, appellant's timely payment of \$5,790 did not exceed the \$6,000 LLC fee assessed for the prior taxable period (TYE 5/1/14). Therefore, the safe harbor is inapplicable and there is no basis for abating the penalty.

The late payment penalty under section 19132

California imposes a late payment penalty for a taxpayer's failure to pay the amount of tax shown on a return before the due date, unless it is established that the late payment was due

²¹ The LLC fee amount appellant reported for the second reporting period was \$11,790. On appeal, FTB now concedes that appellant made a timely payment of \$5,790 for the second reporting period (which amount was the excess available after FTB's application of appellant's overpayment from the first reporting period). The difference, \$6,000, is the underpaid amount.

to reasonable cause and not due to willful neglect. (R&TC, § 19132(a)(1).) The late payment penalty of section 19132 has been made applicable to the LLC fee by virtue of section 17942(c), which provides, in pertinent part, that the LLC fee “shall be collected and refunded in the same manner as the taxes imposed by this part, and shall be subject to interest and applicable penalties.” The late payment penalty is the sum of two figures that may not exceed 25 percent of the unpaid tax. (R&TC, § 19132(a)(2).) The first addend is five percent of the tax that remained unpaid as of the due date. (R&TC, § 19132(a)(2)(A).) The second addend is one-half of one percent of the unpaid tax balance per month for each month, or portion of a month, that the tax remains unpaid after the due date, not to exceed 40 months. (R&TC, § 19132(a)(2)(B).) For these purposes, the due date for payment of tax is determined without regard to any extension of time to file a return. (R&TC, § 19001.)

FTB assessed a late payment penalty for the third reporting period (TYE 12/31/14), because appellant paid its tax on September 15, 2015, which is five months after the due date for paying the LLC fee, and seven months after the due date for paying the annual minimum tax.²² We abate the \$518 late payment penalty for the same reasons we abated the late-filing penalties. We find that there was reasonable cause for the late payment of tax and that the late payment was not due to willful neglect. In this regard, we note the uniqueness and complexity of the situation appellant faced, and the fact that the amount appellant paid in taxes and fees for the first tax year, \$12,590, would have been sufficient to satisfy the amounts due from appellant for the entire 2014 calendar year at issue, but for the restructuring issues encountered (i.e., but for the restructuring, appellant only would have had to pay the maximum LLC fee of \$11,790 once, plus one \$800 annual minimum tax).

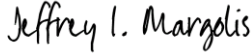
HOLDINGS

Appellant established that the late-filings and payments were due to reasonable cause and not willful neglect. Therefore, the late-filing and late payment penalties are abated. However, appellant failed to establish a basis for abatement of the underpayment of estimated LLC fee penalty.

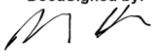
²² In computing the penalty, the computation for the number of months the payment was late was different for the minimum annual tax than for the LLC fee (see footnote 7, *supra*), because the minimum annual tax was due on or before the 15th day of the fourth month of the taxable year, whereas the LLC fee is required to be paid on or before the 15th day of the sixth month of the taxable year (i.e., two months later). (R&TC, §§ 17941(c), 17942(d)(1).)


DISPOSITION

Appellant’s claims for refund for the first and third reporting periods (TYE 5/1/14 & 12/31/14) are granted. Appellant’s claim for refund covering the second reporting period (TYE 10/31/18) is granted, except with respect to the underpayment of estimated LLC fee penalty. For that period, respondent’s assessment of the underpayment of estimated LLC fee penalty is sustained, as modified by respondent’s concession that the penalty amount will be reduced from \$1,179 to \$600.

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Jeffrey I. Margolis
Administrative Law Judge

We concur:

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Andrew J. Kwee
Administrative Law Judge

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John O. Johnson
Administrative Law Judge