

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:) OTA Case No. 18011313
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JAWFEN CHEN) Date Issued: August 20, 2018
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OPINION

Representing the Parties:

For Appellant: Eva Y. Tsai, CPA

For Respondent: David Hunter, Tax Counsel IV

Office of Tax Appeals: William J. Stafford, Tax Counsel III

S. HOSEY, Administrative Law Judge: This appeal is made pursuant to section 19045 of the Revenue and Taxation Code¹ from the action of the Franchise Tax Board (FTB or respondent) on JawFen Chen’s (appellant’s) protest against a proposed assessment in the amount of \$3,282,288 in additional tax and an accuracy-related penalty of \$656,457.60, plus applicable interest, for the 2011 tax year.

Appellant waived her right to an oral hearing and therefore the matter is being decided based on the written record.²

ISSUES

1. Whether appellant has demonstrated that FTB’s calculation of appellant’s stock basis is erroneous.
2. Whether appellant has 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 Pursuant to Assembly Bill 102, The Taxpayer Transparency and Fairness Act of 2017, as amended by Assembly Bill 131 (2017-18 Reg. Sess.), the duty of processing administrative appeals for corporate franchise and income taxes was transferred from the Board of Equalization (Board) to the newly created Office of Tax Appeals.

FACTUAL FINDINGS

A. Receipt of Cisco Stock

1. Appellant's ex-husband founded a company named Ardent Corporation (Ardent). On June 24, 1997, Cisco Systems, Inc. (Cisco) acquired Ardent for Cisco stock.
2. Appellant later divorced her ex-husband on January 15, 1998. After the divorce was final, appellant moved from Connecticut to California. Pursuant to the Marital Separation Agreement, appellant received 211,762.5 shares of Cisco stock. The Cisco stock sat dormant in a brokerage account in Connecticut for a number of years, during which time Cisco issued several stock splits to its shareholders.
3. The Cisco stock remained in the brokerage account and was eventually escheated to the State of Connecticut, and was sold at \$26.088 per share. Appellant, a California resident, received the sales proceeds of \$32,868,973 on November 23, 2011.

B. Appellant's 2011 federal and California returns

4. Appellant reported the sale of the Cisco stock on her 2011 federal Schedule D, listing sales proceeds of \$32,868,973, a tax basis of \$10,482,576, and a gain (for federal purposes) of \$22,386,397. For California purposes, appellant reported on Schedule CA (540) a subtraction of \$22,386,397.³

C. Audit

5. Upon audit, FTB determined that the June 24, 1997 acquisition of Ardent by Cisco was valued at \$156 million via a tax-free exchange (merger) under Internal Revenue Code (IRC) section 351. FTB determined that appellant's ex-husband had an initial tax basis of \$1.00 per share in Ardent's stock in 1997.⁴ Next, FTB calculated the effect of four Cisco stock splits between August 13, 1997 (the Cisco/Ardent stock swap date) and March 19, 2010 (the date the State of Connecticut sold appellant's stock) and computed an adjusted basis of \$0.11 per share in the converted Cisco stock. FTB decreased the

³ A copy of appellant's California return is not in the appeal record; however, a copy of the Notice of Proposed Assessment (NPA) states, *inter alia*, that appellant reported on Schedule CA (540) a subtraction of \$22,386,397.

⁴ FTB's brief also states that the stock had "an initial cost basis which ranged from \$0.33 to \$1.00 per share, prior to any stock splits." FTB later states that it confirmed the basis to be \$1.00 per share.

basis of the 1,259,925 shares sold to \$138,592 (\$0.11 per share x 1,259,925 shares) and increased the reported gain by \$10,343,984. Further, FTB added back the subtraction of \$22,386,397 that appellant listed on her Schedule CA (540).

6. FTB issued an NPA, which listed an additional tax of \$3,365,758 and an accuracy-related penalty of \$673,151.60, based on a substantial underreporting of tax.

D. Protest

7. At protest, FTB reviewed the Registration Statement filed by Cisco with the United States Securities and Exchange Commission on August 14, 1997, which contained a Prospectus for public offering along with the conversion rate of Ardent stock to Cisco stock. Appellant's ex-husband owned 3,000,000 shares of Ardent stock and was to receive 452,748 shares of Cisco stock in exchange for his 3,000,000 shares of Ardent stock. FTB determined that the ex-husband's \$3,000,000 tax basis (calculated at audited \$1.00 per share in the Ardent stock for which he owned 3,000,000 shares of Ardent) in the 452,748 converted Cisco shares equated to a tax basis of \$6.6262 per share (i.e., $\$3,000,000 / 452,748 = \6.6262).
8. Prior to the Marital Separation Agreement, there was a 3/2 stock split as of November 18, 1997, and FTB determined that if appellant's ex-husband had 452,748 shares of Cisco stock, he would then have 679,122 shares with a per share basis of \$4.4175. FTB determined that pursuant to the divorce separation agreement dated January 15, 1998, appellant received 211,762.5 shares of Cisco stock. FTB determined that appellant's per share basis equaled her ex-husband's basis of \$4.4175, in accordance with IRC section 1041(a) and (b).
9. As of August 14, 1998, there was another 3/2 stock split, and based on that stock split the FTB determined that appellant's shares increased to 317,643.75 shares, having a per share basis of \$2.9450. Later, on May 24, 1999, there was a 2/1 stock split, which the FTB determined had increased appellant's shares to 635,287 shares, having a per share basis of \$1.4725. Also, there was one more 2/1 stock split on February 22, 2000, and based on that stock split FTB determined that appellant's shares had increased to

1,270,575 shares, having a per share basis of \$0.7363.⁵ FTB states that this total number of shares (i.e., 1,270,575) is very close to the total number of shares listed on the Cisco stock certificates (i.e., 1,259,925 shares) issued to appellant when the State of Connecticut sold those shares and delivered the proceeds to appellant. Upon applying the \$0.7363 per share basis to 1,270,575 shares, FTB determined that appellant's total basis in the Cisco stock was \$935,524 (i.e., 1,270,575 x \$0.7363 = \$935,524).

10. Appellant received proceeds of \$32,868,973 as of November 23, 2011, from the sale of the 1,259,925 shares. FTB determined that because appellant originally reported that her basis in the shares was \$10,482,576, the cost basis was overstated by \$9,547,052. FTB also determined that with a cost basis of \$935,524 and total proceeds of \$32,868,973, the capital gain amount was \$31,933,449.
11. FTB issued a Notice of Action, which modified the NPA and set forth an additional tax of \$3,282,288 and an accuracy-related penalty of \$656,457.60. In response, appellant filed this timely appeal.

DISCUSSION

Issue 1: Whether appellant has demonstrated that FTB's calculation of appellant's stock basis is erroneous.

A taxpayer bears the burden of proving basis for the purpose of calculating gain or loss on the sale of underlying property. (*Welch v. Helvering* (1933) 290 U.S. 111; *Marcus v. Commissioner*, T.C. Memo 1996-190.) The FTB's assessment is presumed correct and a taxpayer has the burden of proving it to be wrong. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509.) IRC section 1001 provides that the gain on the sale of property shall be the excess of the amount realized over the adjusted basis as defined in IRC section 1011.⁶ IRC section 1011 provides that the adjusted basis for determining the gain from the sale of property shall be the property's initial basis (determined under section 1012 or other applicable sections of that subchapter) with adjustments provided in IRC section 1016. Under IRC section 1016, a property's initial basis must be adjusted for capital expenses and capital recoveries. Capital

⁵ These dates are not consistent with FTB's opening brief – it lists the February 22, 2000 split as being in 1999 – but the numbers are the same otherwise. Regardless of the dates of the two splits, the resulting per share basis calculation remains the same.

⁶ California conforms to IRC sections 1001 and 1011-1016 pursuant to Section 18031.

expenses increase the initial basis and capital recoveries decrease the initial basis so that, on the date of disposition, the adjusted basis reflects the unrecovered cost or other basis of the property.

Appellant asserts that her ex-husband received 452,748 shares of Cisco stock as a result of the merger but that he only had 423,528.25 shares as of the divorce. Appellant contends this demonstrates that 29,219.75 shares of Cisco stock were somehow set aside for tax withholding on capital gain. Appellant further contends that she only received 190,587 shares of Cisco stock pursuant to the Marital Settlement Agreement, not the 211,762.5 shares of stock the Marital Settlement Agreement indicated she received. Appellant asserts that the remaining 29,219.75 shares reflects a tax withholding rate of 20-36 percent. For its part, the FTB contends that appellant has not met her burden of showing that the FTB's calculation of basis is incorrect. Specifically, the FTB asserts that appellant has failed to provide any evidence whatsoever of the cost basis, such as records from Ardent or Cisco, or any contemporaneous records of her own, establishing the cost of each share of stock she received from her ex-husband.

Here, it appears that appellant is incorrectly utilizing the Cisco stock's fair market value from two months after the date Cisco acquired Ardent to arrive at appellant's claimed tax basis in her Cisco stock. Appellant's calculation is incorrect because the Cisco/Ardent merger was a tax-free exchange under IRC section 351 and thus the basis of the stock acquired (Cisco) equals the basis of the stock given up (Ardent). Further, appellant's calculation is incorrect because when property is received incident to divorce, pursuant to IRC section 1041(b) the transfer is treated as a gift, and the recipient assumes the transferor's basis. Accordingly, appellant's basis is equal to her ex-husband's basis in the Cisco stock. Because neither the 351 merger nor the transfer incident to divorce was a recognition event, there was no need for tax withholding. Further, although appellant has argued that her ex-husband had an initial basis in Ardent's stock of \$1.00 to \$10.00 per share,⁷ appellant has failed to provide any evidence to support her contentions, such as records from Ardent or Cisco (or any contemporaneous records of her own) establishing the cost of each share of stock she received from her ex-husband. Based on the available evidence, we find that the FTB's calculations are accurate. Appellant received proceeds of \$32,868,973 from the sale of the 1,259,925 shares. With a cost basis of \$935,524 (i.e., 1,270,575 shares x \$0.7363 per share basis after stock splits = \$935,524) and total proceeds of \$32,868,973,

⁷ According to appellant, her ex-husband's 3,000,000 shares of stock consisted of a basis between \$1.00 to \$3.25 for 2,250,000 shares of the stock and a basis between \$1.00 to \$10.00 for the remaining 750,000 shares of stock.

the capital gain amount was \$31,933,449.

Issue 2: Whether appellant has established that the accuracy-related penalty should be abated.

As noted above, the FTB imposed an accuracy-related penalty based on a substantial understatement. Section 19164, which generally incorporates the provisions of IRC section 6662, provides for an accuracy-related penalty of 20 percent of the applicable underpayment. 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 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 either 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. (§ 19164(d); IRC, § 6664(c)(1); Cal. Code Regs., tit. 18, § 19164, subd. (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).)

Appellant contends that she had a painful divorce just before Cisco acquired Ardent, and that at the time, she had a son fighting with cancer in the hospital and four other children needing her care. Appellant’s representative adds that “the taxpayer did not intend to evade tax and has reported the income as accurately as possible considering the tax payment to the State of Connecticut is still not refunded.” In addition, appellant’s representative states that the audit process was lengthy and that they reported the cost basis as accurately as possible. Based on the foregoing, appellant’s representative concludes “charging the taxpayer with the accuracy related penalty is not fair.”

Appellant has not demonstrated reasonable cause for abatement of the accuracy-related penalty. Appellant has not provided evidence (e.g., a declaration, etc.) demonstrating her level of education and/or her familiarity with tax matters. Further, even though appellant may have hired a tax representative to prepare her 2011 California return, appellant has not demonstrated the efforts she took, if any, to obtain and provide her tax representative with credible and accurate records in a timely manner. In addition, appellant has not provided evidence (declarations, letters, emails, etc.) showing what specific advice the tax representative provided to appellant regarding the calculation of her income for her 2011 return, and that she relied upon the advice of her tax representative regarding the calculation of income.

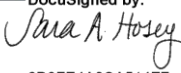
Moreover, we note that as a general rule, appellant had a duty to retain documents for purposes of calculating her taxes in a timely and correct manner. (See IRC, § 6001.) As indicated above, appellant asserts that at the time of the merger between Ardent and Cisco (1997/1998) she had a child suffering from cancer and four other children to raise. Although we sympathize with the difficulties appellant was apparently experiencing in 1997/1998, appellant has not provided facts demonstrating that when she filed her 2011 California return (which was filed more than 10 years after the merger and divorce) she took reasonable steps to calculate her California income.

HOLDINGS

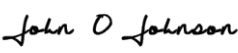
1. Appellant has failed to demonstrate that the FTB's calculation of appellant's stock basis is erroneous.
2. Appellant has failed to establish that the accuracy-related penalty should be abated.

DISPOSITION

FTB's action is sustained.

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Sara A. Hosey
Administrative Law Judge

We concur:

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John O. Johnson
Administrative Law Judge

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