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2019 – OTA – 044
Nonprecedential

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeals of:	) OTA Case Nos. 18011182; 18011184
ALLEN CAPITAL RESOURCE, INC.;	)
	) Date Issued: April 12, 2019
BILL ALLEN	)
	)
	)

OPINION

Representing the Parties:

For Appellants: Joseph Petrucelli, LLM

For Respondent: Bradley W. Kragel, Tax Counsel III

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

J. JOHNSON, Administrative Law Judge: Pursuant to California Revenue and Taxation Code (R&TC) section 19045, Bill Allen (Mr. Allen) and Allen Capital Resource, Inc. (Allen S corp.; together, appellants),[1] appeal an action by respondent Franchise Tax Board (FTB) in proposing assessments for the 2007 through 2010 tax years. With regard to Mr. Allen, FTB proposed: additional tax of $51,200.00, an interest-based penalty of $13,142.89, and a non-economic substance transaction (NEST) penalty of $21,858.00, plus applicable interest, for 2007; additional tax of $22,994.00, an interest-based penalty of $4,052.01, and a NEST penalty of $10,644.00, plus applicable interest, for 2008; additional tax of $15,805.00, an interest-based penalty of $1,929.51, and a NEST penalty of $7,544.00, plus applicable interest, for 2009; and additional tax of $15,739.00, an interest-based penalty of $1,229.02, and a NEST penalty of $7,023.00, plus applicable interest, for 2010. With regard to Allen S corp., FTB proposed the assessment of a NEST penalty of $19,200 for 2007.

Appellants waived their right to an oral hearing and requested that this matter be decided based on the written record.

[1] There are numerous entities discussed herein that were created, owned, or otherwise controlled by Mr. Allen. For the purpose of illustrating the nature of the transaction discussed herein, these entities are referenced by their entity type and relation to Mr. Allen.

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ISSUES

1. Whether Mr. Allen was entitled to deduct $3.2 million in business expenses passed through from Allen S corp.
2. Whether NEST penalties under R&TC section 19774 were properly imposed on Allen S corp. and Mr. Allen.
3. Whether interest-based penalties under R&TC section 19777 were properly imposed on Mr. Allen.

FACTUAL FINDINGS

A. Background

1. On May 25, 2004, Mr. Allen acquired real property in Arizona.[2]
2. During each of the years at issue, Mr. Allen received wages totaling over $300,000 from several entities providing logistics for freight delivery, not involved in the transaction discussed below.

B. Entity Formation

1. In 1989, Mr. Allen and a close business associate[3] co-founded a trucking and logistics company (TTSI), which he continued to work for and receive wages from during the years at issue.
2. On July 21, 2005, Mr. Allen formed the Echo Trust (Allen Kids Trust 2)[4] as a "simple trust," which listed Mr. Allen's children as the beneficiaries and his business associate as the trustee.
3. On December 20, 2005, Integra Strategic Resource Management, LLC (Allen Management LLC) was formed in Nevada. The members of Allen Management LLC were the Allen Kids Trust 2 (99 percent) and Mr. Allen (1 percent). Mr. Allen was the sole employee and manager of Allen Management LLC.

[2] Appellants present assertions regarding the development of this property and its relation to Mr. Allen's entities. Any references herein to an Arizona property or a real estate venture refer to this real property.

[3] References herein to Mr. Allen's business associate all refer to this same individual.

[4] Prior to the years at issue, Mr. Allen had also formed the CABATA Trust (Allen Kids Trust 1). Although appellants change their position as to the formation, purpose, and involvement of Allen Kids Trust 1 in the transaction discussed herein, we find that, based on the evidence provided and for the reasons discussed below, this trust was likewise formed by Mr. Allen for the benefit of his children.

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4. On November 29, 2006, Allen S corp. was incorporated in Nevada. Mr. Allen was Allen S corp.'s sole shareholder. From 2007 to 2009, the sole director was Mr. Allen. Mr. Allen was also the president, chief financial officer, and secretary of the company. On September 5, 2013, Allen S corp. filed a Certificate of Dissolution.
5. On September 9, 2010, Mr. Allen formed Blind Lake Properties, LLC (Allen Properties, LLC), in Arizona. Mr. Allen was listed as a member and manager of Allen Properties, LLC.

C. Strategic Business Services Agreement

1. On November 29, 2006, the same date it was created, Allen S corp. entered into a Strategic Business Services Agreement (SBS Agreement) with Allen Management LLC wherein Allen Management LLC agreed to provide management and strategic business services to Allen S corp. beginning on November 29, 2006, and ending on December 31, 2007. The SBS Agreement was to automatically renew each year, unless one of the parties terminated the agreement. The SBS Agreement provided that the maximum term of the agreement was four years.
2. The SBS agreement stated in part that Allen Management LLC would provide Allen S corp. with the following services: general business management, tax and audit, business development, and contract indemnification and guarantee. It also provided that Allen S corp. would pay Allen Management LLC an annual flat fee of $1.6 million in advance of the services being rendered, and this amount would be allocated among services (other than guarantee and indemnification) listed in an attached allocation schedule. In addition, Allen S corp. would pay an initial fee of $350,000 for the guarantee and indemnification provisions of the agreement.

D. Payments between the Entities[5]

1. On January 1, 2007, the Allen Kids Trust 2's bank account reflected a balance of

[5] Bank account information reported in this section was provided in FTB's brief and partially supported by attached exhibits. Appellants did not contest the amounts reported.

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$50,425.99. Both Allen S corp. and Allen Management LLC had bank account balances that remained at zero until September 2007. In the meantime, Mr. Allen borrowed $3.2 million from the CABATA Trust (Allen Kids Trust 1). Between September 12, 2007, and December 28, 2007, seven deposits totaling $3.2 million were made by Mr. Allen to Allen S corp.'s bank account and, within days, transferred to Allen Management LLC. These deposits were then re-transferred within days, this time from Allen Management LLC to the Allen Kids Trust 2.

2. Thereafter, Allen S corp.'s bank account and Allen Management LLC's bank account had balances of zero until August 21, 2008, when $5,000 was deposited into Allen S corp.'s account and $10,000 was deposited into Allen Management LLC's account.
3. Several payments were made from the Allen S corp. account during 2008, ultimately leaving a balance of $543.69. From December 2008 to December 2009, there was no activity other than a $25 deposit in May 2009 and maintenance fees which were later reversed.
4. Several payments were made from Allen Management LLC's account during August and November 2008, mostly to FTB and the California Secretary of State, leaving a balance of $931.53. From December 2008 to December 2009, there was no activity on the account, except for some maintenance fees which were later reversed.

E. Tax Returns[6]

1. Allen S corp. filed a 2007 California S corporation tax return, reporting gross receipts of zero, and a loss of $3.2 million. The loss was based on deductions for business development of $1,816,875, business management of $1,029,375, guarantee fee of $50,000, indemnification fee of $300,000, and legal fees of $3,750, all paid to Allen Management LLC.
2. Allen Management LLC filed a 2007 LLC tax return reporting income of $3.2 million. It reported costs of goods sold (COGS) of $3,168,000, which consisted of cash distributions to the Allen Kids Trust 2 for "service contracts." The Allen

[6] The parties did not provide copies of the tax returns on appeal, but they do not dispute this information, which was provided in the briefing.

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Kids Trust 2 filed a 2007 California Fiduciary Income Tax Return (Form 541) reporting total income of $292,733.

3. Mr. Allen filed a 2007 California personal income tax return, reporting total wages of $432,265, and claimed a loss from Allen S corp. of $3.2 million. Mr. Allen reported adjusted gross income of negative $2,576,135, generating a net operating loss (NOL) carryover of $2,675,593.

4. Allen S corp. filed a 2008 California S corporation tax return reporting zero in gross receipts and a loss of $4,432. Allen Management LLC filed a 2008 LLC return also reporting zero in gross receipts. Allen Kids Trust 2 filed a 2008 California fiduciary income tax return reporting total income of $219,643.

5. On Mr. Allen's 2008 California personal income tax return, he reported total wages of $356,689, and adjusted gross income of negative $2,295,539. Mr. Allen claimed a NOL carryover from 2007 of $2,675,593.

6. Allen S corp. filed a 2009 California S corporation tax return, again reporting zero in gross receipts, and reporting a loss of $2,250. Allen Management LLC filed a 2009 California LLC Return also reporting zero in gross receipts. Allen Kids Trust 2 filed a 2009 California Fiduciary income tax return reporting a loss of $3,480.

7. On Mr. Allen's 2009 California personal income tax return, he reported wages of $308,673, and adjusted gross income of negative $2,126,281. Mr. Allen claimed a NOL carryover from prior years of $2,397,577.

F. Audit

1. In 2011, FTB initiated an examination of Allen S corp. and Mr. Allen for the 2007, 2008, and 2009 tax years. In 2012, FTB issued Audit Issue Presentation Sheets (AIPS) to Allen Kids Trust 2, Allen S corp., Allen Management LLC, Mr. Allen, and Mr. Allen's children.[7] FTB disallowed Allen S corp.'s business expense deductions of $3.2 million, disallowed Allen Management LLC's COGS expense of $3,168,000, increased Allen Kids Trust 2's income by $3,168,000, and assessed additional tax to Mr. Allen resulting from the disallowance of flow-

[7] The 2012 AIPS are not in the record. However, the parties do not dispute that FTB issued AIPS to appellant as detailed above.

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through losses from Allen S corp. The AIPS to Allen S corp. stated in part that FTB was proposing a NEST penalty because the taxpayer's transaction lacked economic substance, and the AIPS to Mr. Allen stated that FTB was proposing a NEST penalty, an interest-based penalty, and an accuracy-related penalty.

2. On October 14, 2012, appellants responded to the AIPS, asserting that Mr. Allen had previously formed the Allen Kids Trust 1, which was established for the benefit of Mr. Allen's children. Appellants stated that the Allen Kids Trust 1 owned the stock of a C corporation that had been set up to receive management fees and provide pension benefits to Mr. Allen.[8] Appellants stated that Mr. Allen borrowed from the Allen Kids Trust 1 in order to capitalize Allen S corp. Appellants further stated that these funds were then transferred to Allen Management LLC to aid in a merger of Allen Kids Trust 1 and Allen Kids Trust 2. Appellants asserted that there were promissory notes and a pledge agreement put in place between Mr. Allen and the Allen Kids Trust 1. Appellants stated that when Mr. Allen would borrow from the Allen Kids Trust 1, he would contribute the funds to Allen S corp., essentially creating a back-to-back borrowing scenario. Although FTB requested appellants to provide the Allen Kids Trust 1 agreement and related documents, appellants refused to provide those documents or the records relating to the C corporation owned by the Allen Kids Trust 1.

3. On May 23, 2013, FTB withdrew its proposed assessments against the Allen Kids Trust 2 and its beneficiaries. On May 29, 2013, FTB sent a second Audit Issue Presentation Sheet (AIPS 2) to Allen S corp., disallowing the business deductions of $3.2 million and proposing a NEST penalty of $19,200. On May 30, 2013, FTB also sent a second Audit Issue Presentation Sheet (also called AIPS 2) to Mr. Allen, disallowing the flow-through loss of $3.2 million in 2007 and disallowing the NOL carryovers for 2008 through 2010. FTB also proposed the NEST penalty, an interest-based penalty, and an accuracy-related penalty against Mr. Allen.

4. On July 23, 2013, FTB issued Notices of Proposed Assessment (NPA's) to Mr.

[8] As noted in the *Protest* section below, appellants subsequently changed their position to assert that appellant did not form the Allen Kids Trust 1, and that the trust did not provide pension benefits.

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Allen in accordance with the AIPS 2 issued to him for the years at issue, assessing additional tax, interest and penalties. On August 5, 2013, FTB issued an NPA to Allen S corp. for 2007, proposing a NEST penalty of $19,200.

G. *Protest*

1. Appellants filed timely protests with FTB, and FTB issued a request for additional information to appellants. In a letter dated October 29, 2015, appellants responded. Appellants asserted that Allen S corp. should not be liable for the NEST penalty because no additional tax had been assessed against Allen S corp. With regard to the Allen Kids Trust 1, appellants changed their position and asserted that the Allen Kids Trust 1 was not formed by Mr. Allen for the benefit of his children, and asserted that Mr. Allen borrowed funds in his own name to fund Allen S corp. (but did not provide documentation showing the source of the borrowed funds). Appellants indicated that Mr. Allen was the employee at Allen Management LLC and that he intended to provide Allen S corp. with general business management and business development services. Appellants further indicated that Allen Management LLC and Allen S corp. intended to outsource the audit and tax services to an appropriate party. As for the services under the "service contracts" for which Allen Management LLC claimed the COGS deduction in 2007, appellants stated that the payments were estimates of amounts required to be expended in "various ventures" being considered at the time.
2. Appellants also stated that the "business development" deduction was an estimate of the amount that would have been spent during the life of the SBS Agreement, including travel, legal fees, and development fees associated with a real estate venture. Appellants asserted that the amount of the "general business management" deduction was an estimate based on the amount of salary appellant Mr. Allen would have received and reported on his tax return had he continued in his current employment. Appellants contended that the intent of the business structure was to replace the income Mr. Allen was earning in his employment, and that the amount to be paid to him was based on an approximation of his 2007 and 2008 wages divided over the life of the SBS Agreement.
3. Mr. Allen pursued, in his personal capacity, an opportunity to buy-out TTSI

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instead of pursuing the other various ventures through Allen S corp. As for one of those other ventures, the real estate venture in Arizona, appellants asserted that Mr. Allen was involved in the real estate venture individually; none of his related entities were involved. Appellants contended that Mr. Allen purchased the Arizona property in 2004 and took steps to change the zoning on the property, and that the change in zoning was finalized in 2012. Appellants asserted that Allen S corp. and Allen Management LLC were formed in anticipation of developing this Arizona property. However, appellants contended, due to the challenging economic conditions, Mr. Allen abandoned the real estate venture in favor of pursuing personally the buy-out opportunity of TTSI.

4. FTB issued Notices of Action to appellants for the years at issue in February 2017, affirming the NPAs. Appellants then filed this timely appeal.

DISCUSSION

Issue 1: Whether Mr. Allen was entitled to deduct $3.2 million in business expenses passed through from Allen S corp.

Internal Revenue Code (IRC) section 162, as incorporated into California law by R&TC section 24343, generally allows a deduction for trade or business expenses so long as the expenses are ordinary and necessary and paid or incurred during the taxable year in carrying on any trade or business. To be engaged in a trade or business: (1) the taxpayer's primary purpose for engaging in the activity must be for income or profit, and (2) the taxpayer must be involved in the activity with continuity and regularity. (*Commissioner v. Groetzinger* (1987) 480 U.S. 23; *Appeal of Hill*, 81-SBE-049, May 19, 1981.)[9] Even though a taxpayer decides to enter into business, the taxpayer has not engaged in carrying on a trade or business until such time as the business functions as a going concern and performs the activities for which it was intended. (*Appeal of Hill*, *supra*.)

IRC section 162(a)(1) allows a business to deduct "a reasonable allowance for salaries or other compensation for personal services actually rendered" as an ordinary and necessary business expense. To be deductible, the payment must be (1) purely for services rendered and

[9] Board of Equalization cases may be found on the Board's website: <www.boe.ca.gov/legal/legalopcont.htm>.

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(2) reasonable in amount. (*International Capital Holding Corp. v. Commissioner*, T.C. Memo. 2002-109.) The business expense must be "directly connected with or pertaining to the taxpayer's trade or business . . . ." (Treas. Reg. § 1.162-1(a).) The taxpayer must demonstrate that management services were actually rendered in order to deduct management fees as a business expense. (*Elick v. Commissioner*, T.C. Memo. 2013-139.)

Taxpayers bear the burden of proving their right to a claimed deduction. (*INDOPCO, Inc. v. Commissioner* (1992) 503 U.S. 79.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Magidow*, 82-SBE-274, Nov. 17, 1982.) A taxpayer's failure to produce evidence that is within his or her control gives rise to a presumption that such evidence is unfavorable to his or her case. (*Appeal of Cookston*, 83-SBE-048, Jan. 3, 1983.)

Appellants have not demonstrated that Allen S corp. was carrying on a trade or business. With regard to the Arizona real estate development project, the evidence in the record reflects that only Mr. Allen, as an individual, pursued the development project. Mr. Allen purchased the Arizona property in his individual capacity in 2004, over a year before Allen Management LLC and Allen S corp. were formed. Mr. Allen did not subsequently contribute the property to Allen S corp. Mr. Allen, as an individual, made efforts to amend the zoning rights of the Arizona property, and was at all times represented as the property owner. Appellants provided a 2007 housing report prepared for the City of Bullhead, Arizona, as evidence that Mr. Allen's assessment of the residential market in the area of the Arizona property was correct. However, appellants did not show how Mr. Allen's individual research and other activities regarding the Arizona property were related to Allen S corp. or Allen Management LLC. In addition, appellants did not offer any legal authority for their contention that Mr. Allen's individual activities should be attributed to Allen S corp. by virtue of Mr. Allen being Allen S corp.'s sole shareholder and director.[10]

Appellants assert that Mr. Allen, as Allen Management LLC's employee, intended to provide Allen S corp. with general business management and business development services. Appellants did not provide any evidence to support a finding that Mr. Allen's real estate activities were performed on behalf of either Allen S corp. or Allen Management LLC. Moreover, Mr. Allen's tax returns during the years at issue do not report any wages from Allen

[10] Furthermore, *Moline Properties, Inc. v. Commissioner* (1943) 319 U.S. 436, cited to by appellants for the proposition that Allen S corp. must be recognized as a separate entity, is contrary to their position that Mr. Allen's actions (as an individual) should be considered the actions of the corporation.

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Management LLC or Allen S corp. In addition, while appellants assert that Mr. Allen intended to contribute the Arizona property to Allen Properties, LLC, which was not formed until 2010, and then to later contribute the Allen Properties, LLC, interest to Allen S corp., there is no evidence that Mr. Allen transferred either the Arizona property or the Allen Properties, LLC, interest to Allen S corp.

Further, the bank records show that Allen S corp. was not involved in the real estate development project during the years at issue. Allen S corp.'s bank account activity was limited to the transfer of the $3.2 million to Allen Management LLC in 2007, and minor unrelated payments in later years. These financial records show that neither entity was involved in any activity relating to the Arizona property during the years at issue. Appellants did not show that Allen S corp. or Allen Management LLC engaged in any of the real estate development activities in Arizona, let alone engage in that activity with continuity and regularity with the intent to profit from that activity.

Appellants provided a letter from a third party that contained a proposed franchise agreement, asserting that it pertained to Allen S corp.'s business.[11] However, the records reflect that the third party approved a prospective franchise business on April 30, 2010, only as to Mr. Allen and his son. There was no mention of Allen S corp. in that franchise letter or the attached agreement. Further, this potential business venture occurred three years after the deductions were claimed in 2007. Appellants did not explain or demonstrate what activities Allen S corp. engaged in during 2007 that might have generated expenses related to the franchise opportunity. Appellants also did not show that Allen S corp. was involved with this purported activity with continuity and regularity with the intent to profit from this activity.

Accordingly, we find that Allen S corp. was not engaged in a trade or business during the years at issue. Therefore, we need not consider whether the claimed expenses were ordinary and necessary. Since Allen S corp. was not operating a trade or business during the years at issue, FTB properly determined that Allen S corp. is not entitled to deduct the reported expenses and Mr. Allen is not entitled to the corresponding $3.2 million in flow-through losses.

Issue 2: Whether the NEST penalty under R&TC section 19774 should be imposed on Allen S corp. and Mr. Allen.

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[11] The letter, dated April 30, 2010, was from a junk hauling company and included a proposed franchise agreement between the company and Mr. Allen and his son.

R&TC section 19774(a) provides that, "[i]f a taxpayer has a noneconomic substance transaction understatement for any taxable year, there shall be added to the tax an amount equal to 40 percent[12] of the amount of that understatement."[13]

A "noneconomic substance transaction" includes the disallowance of any loss, deduction or credit, or addition to income attributable to a determination that the disallowance or addition is attributable to a transaction or arrangement that lacks economic substance including a transaction or arrangement in which an entity is disregarded as lacking economic substance. (R&TC, § 19774(c)(2)(A).) A transaction shall be treated as lacking economic substance if the taxpayer does not have a valid nontax California business purpose for entering into the transaction. (*Ibid.*)

Once a NEST penalty has been proposed and an NPA has been sent, only FTB's Chief Counsel "may compromise all or any portion of that penalty." (R&TC, § 19774(d)(1).) Notwithstanding any other law or rule of law, any NEST penalty determination by FTB's Chief Counsel "may not be reviewed in any administrative or judicial proceeding." (R&TC, §19774(d)(3).)

The sham transaction and economic substance doctrines are judicial doctrines developed to prevent a taxpayer from reaping tax benefits from a transaction that lacks economic substance. There are two types of shams: a sham in fact and a sham in substance. A sham in fact is a transaction that never occurred, while a sham in substance is a transaction that occurred but lacks the substance its form represents. (*Kirchman v. Commissioner* (11th Cir. 1989) 862 F.2d 1486.) In determining whether a transaction is a sham, courts have developed a two-part analysis: (1) whether the taxpayer has demonstrated a business purpose for engaging in the transaction other than tax avoidance (the business purpose factor); and (2) whether the taxpayer has shown that the transaction had economic substance beyond the creation of tax benefits (the economic substance factor). (*Casebeer v. Commissioner* (9th Cir. 1990) 909 F.2d 1360, 1363; *Appeal of Alyn*, 2009-SBE-001, May 27, 2009.) This two-part analysis is not a conjunctive test or "rigid two-step

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[12] This penalty may be reduced to 20 percent with respect to any portion for which the "relevant facts affecting the tax treatment of the item are adequately disclosed in the return or a statement attached to the return." (R&TC, § 19774(b)(1).) Appellants made no such disclosure.

[13] The term "noneconomic substance transaction understatement" is defined as "any amount which would be an understatement under Section 6662A(b) of the [IRC], as modified by subdivision (b) of Section 19164.5 if Section 6662A(b) of the [IRC] were applied by taking into account items attributable to noneconomic substance transactions rather than items to which Section 6662A(b) applies." (R&TC, § 19774(c)(1).)

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analysis," but rather "precise factors" that need to be weighed to determine whether the transaction had any practical economic effects other than the creation of tax losses. (*Casebeer v. Commissioner, supra,* 909 F.2d at p. 1363.)

The business purpose factor involves an examination of the subjective factors that motivated the taxpayer to engage in the transaction at issue. (*Casebeer v. Commissioner*, *supra*, 909 F.2d at p. 1364.) The economic substance factor looks at whether the substance of a transaction reflects its form and involves an examination of whether the transaction was objectively capable of creating a profit or affecting the taxpayer's financial situation. (*Id*. at p. 1365.) "To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress." (*Commissioner v. Court Holding Co.* (1945) 324 U.S. 331, 334.)

The transaction to be analyzed is the one that gave rise to the alleged tax benefit. (*Coltec Industries, Inc. v. United States* (Fed. Cir. 2006) 454 F.3d 1340, 1356 (*Coltec*).) A lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance. Additionally, the taxpayer bears the burden of proving that the transaction has economic substance. (*Id.* at pp. 1355 & 1356.)

Business purpose

Appellants assert that there were several nontax business purposes for the transaction (i.e., the SBS Agreement and the resulting transfer of funds between related entities). Appellants contend that Mr. Allen was interested in forming a business structure through which he could seek new business opportunities while separating the assets of the business from the operations of the business and thereby insulate appellants from any potential creditor claims. Appellants assert that these business purposes are evidenced by the fact that Mr. Allen, operating as Allen Management LLC's employee and working on behalf of Allen S corp., purportedly researched land issues relating to the Arizona property, purchased land,[14] expended money relating to the land, and transferred capital to Allen S corp.

First, we note that appellants refused to provide any evidence to substantiate the source of the funds Allen S corp. paid to Allen Management LLC, and we therefore presume that the evidence, if provided, would be unfavorable to appellants. (See *Appeal of Cookston*, 83-SBE-

[14] The only land allegedly related to the operations of Allen S corp. was the Arizona property, which was purchased years before Allen S corp. was formed.

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048, *supra*.) Accordingly, and based on previous statements made by appellants during audit that now appear contrary to their interest, we find that the $3.2 million that was transferred between entities controlled by Mr. Allen originated from the Allen Kids Trust 1. This results in the funds having been ultimately taken from Allen Kids Trust 1 by Mr. Allen, transferred to Allen S corp., then transferred to Allen Management LLC, and ultimately transferred to Allen Kids Trust 2 (with a marginal amount removed as fees along the way). As discussed above, Allen S corp was not engaged in a trade or business, nor have appellants satisfactorily shown that Allen S corp was ever intended to engage in a trade or business. Therefore, we do not find credible appellants' assertions that the transfer of funds between related entities served the claimed purpose of insulating appellants from potential creditor claims. Contrary to appellants' assertions that the transferring of funds served a business purpose, it is clear that it only served the tax-motivated purpose of the tax-exempt movement of money between Mr. Allen's trusts while generating a large phantom deduction.[15]

Second, Mr. Allen's actions contradict the stated business purpose of creating Allen S corp. and Allen Management LLC, that being the pursuit of new business ventures after Mr. Allen left his employment at TTSI. Mr. Allen remained at TTSI and related trucking companies from 2007 to 2010. The claimed losses generated by the transaction described herein effectively sheltered Mr. Allen's wage income from his trucking activities from taxation. In addition, the record shows that Mr. Allen performed the real estate activities discussed herein in his individual capacity, and not on behalf of Allen S corp. and Allen Management LLC. Appellants argue that "[t]he existence of the business activities in this case should lead to the conclusion that the corporation was a legitimate entity and the payments made pursuant to the contract were intended for a valid business purpose." However, as found above, Allen S corp. did not engage in the purported trade or business asserted by appellants. Therefore, appellants have not shown any business activities that support a finding of a business purpose for the transaction involving Allen S corp. and Allen Management LLC at issue here, let alone a business purpose commensurate to the $3.2 million loss claimed.

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[15] As noted in the *Audit* section of the Factual Findings above, appellants originally stated that the transaction was intended to simplify Mr. Allen's estate planning by combining the funds of the Allen Kids Trust 1 with the funds of the Allen Kids Trust 2. This further supports our conclusion above. At protest and on appeal, appellants attempted to change their position, claiming that the involvement of Allen Kids Trust 1 in the transaction was not relevant to the issues on appeal. On that ground, appellants refused to provide requested documentation showing the source of the $3.2 million that Mr. Allen transferred to Allen S corp.

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Economic substance

The transaction that gave rise to the tax benefit was the SBS Agreement between Allen S corp. and Allen Management LLC, which provided Allen S corp. with a deduction that resulted in a loss that flowed through to Allen S corp.'s sole shareholder, Mr. Allen, to offset Mr. Allen's earned income. Mr. Allen was the sole owner and employee of Allen S corp. and the sole employee and manager of Allen Management LLC. Mr. Allen created a corporation and a limited liability company through which he hired himself to provide business advice to himself. The $3.2 million in payments made pursuant to the SBS Agreement was based on an estimate of the wages Mr. Allen would have received if he were to continue working at TTSI instead of dedicating his energies to new business ventures for Allen S corp. However, Mr. Allen did not leave his position at TTSI during the years at issue. Moreover, the entities did not conduct any business activity in the years at issue. Appellants did not show that any services were provided to justify the payments. (See *Elick v. Commissioner*, T.C. Memo. 2013-139; cf. *International Capital Holdings Corp. v. Commissioner*, *supra* [deduction allowed where services were both needed and provided, and payment was negotiated by disinterested parties and reasonable in amount].) The banking history shows little activity by Allen S corp. and Allen Management LLC from 2007 through 2010 apart from the transfer of $3.2 million from Allen S corp. to Allen Management LLC, and then to the Allen Kids Trust 2. There were no practical effects of the transaction, other than to provide a tax benefit to Mr. Allen.

As discussed in Issue 1, appellants did not substantiate that Mr. Allen provided services to Allen S corp. as Allen Management LLC's employee. Through the use of Allen S corp., Allen Management LLC, and the SBS Agreement, funds were ultimately transferred from appellant's old trust (Allen Kids Trust 1) to appellant's new trust (Allen Kids Trust 2), with no real economic activity. Appellants engaged in this circular transfer of money solely for the purpose of creating tax benefits. (See, e.g., *Merryman v. Commissioner* (5th Cir. 1989) 873 F.2d 879, 882.) Accordingly, the evidence in the record supports our finding that the formation of both Allen S corp. and Allen Management LLC, as well as the SBS Agreement, lacked a valid business purpose and economic substance. Appellants entered into the transaction for the purpose of avoiding income tax, as the transaction enabled Mr. Allen to offset his earned income with the flow-through losses. Appellants failed to demonstrate a valid nontax California business purpose for entering into the transaction. Payments between related entities for

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activities never performed and not associated with the entities at issue, for which a $3.2 million loss was claimed with no corresponding gain reported, is activity without economic substance. As for appellants' contention that the penalty should be abated for reasonable cause because they relied in good faith on the advice of counsel in entering into and reporting the transaction, there is no reasonable cause exception to the imposition of the NEST penalty. Accordingly, we find that the NEST penalty was properly imposed against Mr. Allen.[16]

With respect to the imposition of the NEST penalty against Allen S corp., appellants argue that the plain language of R&TC section 19774 does not allow the imposition of the penalty if no additional tax is proposed to be assessed. Appellants contend that R&TC section 19774 expressly states that the penalty is "added to the tax" in an amount equal to 40 percent of the amount of the understatement. Appellants argue that, as no additional tax was determined to be due from Allen S corp., the NEST penalty may not be applied to Allen S corp. Appellants argue that there is no other reasonable interpretation of R&TC section 19774. Appellants' attempt to add an additional requirement that the penalty may only apply if the entity has a tax liability for the same year is unfounded. While the penalty is "added to the tax" for the purposes of being collected as a tax, the penalty is calculated without regard to any tax liability and there is nothing in the statute that prevents imposition of the penalty in instances where there is not also a tax liability.

The amount of the penalty is calculated based on the amount of the understatement, as defined in IRC section 6662A. Here, Allen S corp. reported deductions of $3.2 million[17] in 2007 that FTB found, and we concur, should be disallowed. The result is an increase in taxable income of $3.2 million,[18] which, when the 1.5 percent tax rate for S corporations in California is applied (pursuant to R&TC section 23802(b)(1)), equates to an "understatement" within the meaning of IRC section 6662A, as incorporated by R&TC section 19774, of $48,000. A NEST

[16] Appellants did not raise arguments regarding the calculation of the penalty as applied to Mr. Allen, as they did with regard to the penalty applied to Allen S corp. Therefore, and in accordance with our limited jurisdiction under R&TC section 19774(d), we only address the applicability of the penalty against Mr. Allen and not the calculation.

[17] A breakdown of the specific deductions claimed is listed in section E-1 of our *Factual Findings* above.

[18] R&TC section 19774 incorporates the definition of an understatement as defined in IRC section 6662A(b), wherein it states that the definition of an "increase in taxable income" includes "any reduction of the excess of deductions allowed for the taxable year over gross income for such year."

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penalty of 40 percent of $48,000 equals the penalty amount of $19,200 proposed by FTB. Thus, we find that the NEST penalty was properly imposed against Allen S corp.

Issue 3: Whether the interest-based penalty under R&TC section 19777 was properly imposed.

R&TC section 19777(a) provides that, if a taxpayer has been contacted by FTB regarding an abusive tax avoidance transaction, and has a deficiency attributable to an abusive tax avoidance transaction, FTB will impose a penalty equal to 100 percent of the interest payable for the period beginning on the due date of the payment of the tax and ending on the date the NPA is mailed. This is applicable to any notices mailed after March 24, 2011. An "abusive tax avoidance transaction" includes any transaction to which R&TC section 19774 (i.e., the NEST penalty) applies. (R&TC Code, § 19777(b)(5).) As discussed above in Issue 2, the NEST penalty pursuant to R&TC section 19774 applies to the transaction in this case and, therefore, the transaction is an abusive tax avoidance transaction for purposes of the interest-based penalty.

The parties dispute whether appellants received the notification required pursuant to R&TC section 19777(a). Appellants assert that the initial contact must provide notification of the potential abusive tax avoidance transaction. However, the plain language of R&TC section 19777 does not support such a narrow interpretation. The statute only requires that "a taxpayer has been contacted by the Franchise Tax Board regarding an abusive tax avoidance transaction." We note that the record reflects FTB notified Mr. Allen of the potential abusive tax avoidance transaction in the first AIPS, dated September 20, 2012, and in the AIPS 2 issued to him dated May 30, 2013, wherein FTB informed him that it was disallowing the flow-through loss of $3.2 million and the related NOL carryovers. Those AIPS also informed Mr. Allen of the applicability of the NEST and interest-based penalties.

Appellants argue that the AIPS were not sufficient notice because they did not allow appellants to resolve the matter prior to the issuance of the NPA, adding that the AIPS 2 was too late in the process to be meaningful as the NPA was issued on July 23, 2013. We note, however, that the first AIPS was issued to Mr. Allen in September 2012, and appellants responded to the AIPS with lengthy legal arguments regarding the economic substance and business purpose of the transaction at issue, including their assertion that the NEST penalty was not applicable. As such, appellants were clearly put on notice regarding their abusive tax avoidance transaction. Appellants note that R&TC section 19777(d)(1) provides taxpayers with the opportunity to reduce the amount of the penalty by filing an amended return prior to the issuance of the NPA.

However, appellants chose to contest FTB's position rather than file an amended return reporting the abusive tax avoidance transaction.

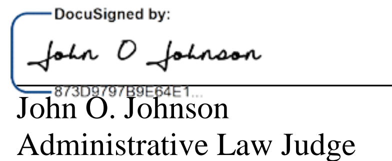
Appellants assert that the auditor informed them that appellants could not file amended tax returns. Appellants argue that this purported advice contradicts R&TC section 19777(d)(1). However, appellants have not provided any evidence of the purported advice from the auditor. Additionally, the statutory provision that allows taxpayers to file an amended return places no duty on FTB to inform taxpayers of this option. Therefore, we hold that the interest-based penalty was properly imposed on Mr. Allen.

HOLDINGS

1. FTB properly disallowed the $3.2 million in pass-through business expenses from Allen S corp. deducted by Mr. Allen because appellants have not shown that Allen S corp. was operating a trade or business.
2. The NEST penalty was properly imposed on Mr. Allen and Allen S corp.
3. The interest-based penalty was properly imposed on Mr. Allen.

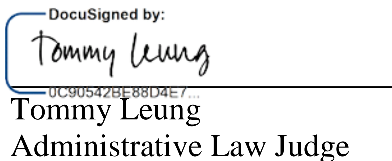
DISPOSITION

FTB's proposed assessments are sustained in full.

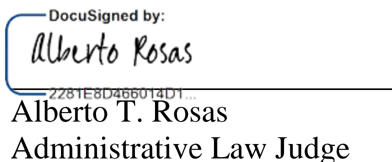


John O. Johnson
Administrative Law Judge

We concur:



Tommy Leung
Administrative Law Judge



Alberto T. Rosas
Administrative Law Judge