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2019 – OTA – 112
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18012102
	)
MARSHALL REDDICK	) Date Issued: April 22, 2019
	)
	)
	)

OPINION ON REHEARING[1]

Representing the Parties:

For Appellant: Joseph E. Mudd, Attorney

For Respondent: Chris Haskins, Tax Counsel III
Michael Cornez, Attorney V

For Office of Tax Appeals: Neha Garner, Tax Counsel III

K. GAST, Administrative Law Judge: Pursuant to California Revenue and Taxation Code (R&TC) section 19045,[2] Marshall Reddick (appellant) appeals actions by respondent Franchise Tax Board (FTB) in proposing the following assessments, plus interest:

Tax Year	Tax	NEST Penalty[3]	IB Penalty[4]
2003	$86,454	$36,795	$39,279.98
2004	$403,617	$161,447	$159,240.24
2005	$552,003	$199,365	$179,661.57
2006	$259,170	$96,095	$60,876.18

[1] The Board of Equalization (BOE) previously decided this matter based on the written record and, consequently, without an oral hearing. The BOE issued a summary decision finding for respondent on most of the issues in dispute. Appellant then filed a petition for rehearing, which the BOE granted. This opinion constitutes our opinion on rehearing in the sense that the BOE did "hear" the original appeal, albeit based solely on the briefs and documentary evidence.

[2] Unless otherwise indicated, all statutory references are to the R&TC for the tax years at issue.

[3] The NEST penalty stands for the "noneconomic substance transaction" penalty imposed under R&TC section 19774.

[4] The IB penalty stands for the "interest-based" penalty imposed under R&TC section 19777.

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Administrative Law Judges Kenneth Gast, Sara A. Hosey, and Jeffrey I. Margolis held an oral hearing for this matter in Van Nuys, California, on January 25, 2019. At the conclusion of the hearing, the record was closed and this matter was submitted for decision.

ISSUES

1. Whether FTB erred in reallocating to appellant taxable income from Ocean Living, Inc. (OLI), an S corporation, based on its determination that appellant's employee stock ownership plan (ESOP) strategy lacked a nontax business purpose and economic substance, and therefore was a sham for the 2003 through 2006 tax years.
2. Whether FTB properly imposed the NEST penalty for the 2003 through 2006 tax years.
3. Whether FTB properly imposed the IB penalty for the 2005 and 2006 tax years.[5]

FACTUAL FINDINGS

General Background

1. During the tax years at issue, appellant was a California resident and businessman who specialized in real estate.
2. On May 25, 2000, appellant incorporated Marshall Reddick Realty, Inc. (MRRI) and became its sole shareholder. MRRI elected subchapter S corporation status, effective August 1, 2000. MRRI was engaged in the business of real estate sales and transactions.
3. On December 18, 2003, appellant incorporated OLI. Like MRRI, OLI elected subchapter S corporation status, effective on the date of its incorporation. At this time, appellant was the sole shareholder of OLI.
4. OLI was formed to provide management services exclusively to MRRI. To accomplish this, MRRI transferred some, but not all, of its employees to OLI.[6]
5. Sometime shortly after its incorporation, OLI established an ESOP for its employees (i.e., for some of MRRI's former employees). It served as the ESOP's employer plan sponsor. Appellant, in his individual capacity, served as the trustee for the ESOP. He was

[5] On rehearing, FTB conceded the IB penalties for the 2003 and 2004 tax years.

[6] Because MRRI retained some of its employees, it continued to deduct officer compensation, salary and wage expenses, as reflected on lines 7 and/or 8 of page 1 of MRRI's Internal Revenue Service (IRS) Forms 1120S for years at issue. Also for these same years, MRRI deducted employee benefit expenses, which indicates it had a retirement plan in place for the employees who were not transferred. However, the record is silent as to when MRRI transferred some of its employees to OLI, as well as the exact number of employees transferred.

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therefore responsible for the safekeeping of the trust fund that contained all assets contributed to the ESOP.

6. On December 28, 2003, appellant and the ESOP entered into a series of written agreements, whereby appellant agreed to loan the ESOP $10,000 and the ESOP agreed to use those loan proceeds to purchase from appellant all 100,000 shares of OLI's issued and outstanding common stock. These agreements were signed (and countersigned, as applicable) by appellant—both as the lender/seller, in his individual capacity, and as the borrower/buyer, in his capacity as the ESOP's trustee.[7]

7. Based on its 2005 Form 5500—which is used to satisfy annual reporting requirements with the IRS and other federal government agencies—the ESOP indicated it had an effective plan date of January 1, 2004.[8] Despite this effective date, OLI's 2003 IRS Form 1120S lists the ESOP as OLI's sole shareholder as of OLI's first taxable year end, December 31, 2003, which, with an incorporation date of December 18, 2003, covered less than a month.

8. In 2004 and 2005, the ESOP had 40 and 60 active participants, respectively.[9] These participants appeared to be all, or most, of OLI's employees for those years.

9. Appellant was never a participant in the ESOP and ceased having any ownership interest in OLI after selling his shares to the ESOP. However, appellant served as OLI's CEO for all the tax years under review. Appellant testified that, during this time, he ran the day-to-day operations of OLI and signed OLI's tax returns as its CEO. The record reflects he was compensated for services rendered to OLI in the form of wages exceeding $100,000 for both 2004 and 2006, and he signed checks on OLI's behalf during 2004 and 2005.[10]

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[7] In a document entitled "Action by Unanimous Written Consent of the Plan Administrator of [OLI]," appellant, listed as the ESOP's plan administrator, authorized the ESOP to enter into these transactions. Appellant executed that document on December 28, 2003.

[8] We note that this form, among others found in the record, was signed by an attorney named Daniel E. Carpenter and dated March 29, 2007. The 2005 Form 5500 indicated that he was the plan administrator of the ESOP, even though other documentation, discussed above, indicated appellant held that position at some earlier point in time. We further note that the 2005 Form 5500 in the record was being amended for an unspecified reason, which may explain why it was dated in 2007. We also note that many of the relevant IRS ESOP forms for the years under review either are not in the record or are incomplete and missing pages.

[9] The record does not provide the number of participants in the ESOP for the 2003 and 2006 tax years.

[10] The record does not contain any information on these topics for the other tax years at issue.

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10. During an audit, the IRS reviewed the ESOP's 2004 Form 5500 and determined, in a no-change letter dated August 12, 2008, that the return would be accepted as filed.[11] Appellant testified that, due to this audit, he resigned as OLI's CEO in 2008 to ensure the ESOP would have no issues in the future meeting the technical requirements of the tax law. It appears appellant may have resigned based on certain IRS findings recommending he step down as an officer of OLI while it was owned by the ESOP.[12]
11. Based on an independent business valuation and appraisal report dated April 23, 2007, the fair market value of the OLI stock held by the ESOP was $4.3 million as of December 31, 2005. This valuation was about half of the value determined as of December 31, 2004, which is reflected in another valuation and appraisal reported, also dated April 23, 2007, that was prepared by the same firm.
12. During the tax years at issue, appellant was the sole shareholder and CEO of MRRI, and had complete authority over it and controlled its day-to-day operations.

Management Fees

13. MRRI and OLI entered into a management agreement entitled "Employment Services Contract." Although partially illegible, the effective date of the agreement is 2009, which is after the tax years at issue. Appellant signed the agreement on behalf of MRRI and as the president of OLI.
14. The agreement provided that OLI, as an independent contractor, would "manage all phases of [MRRI's] business operations," which included "the general responsibility and authority to effectively supervise and manage the business operations of [MRRI] in such a manner as to ensure the efficient and profitable operation of [MRRI]." Specifically, OLI's employment services included, but were not limited to, recruiting, selecting,

[11] We note that the record contains IRS Form 5300, which is entitled "Application for Determination for Employee Benefit Plan," and IRS Form 5309, which is entitled "Application for Determination of Employee Stock Ownership Plan," both of which are dated April 10, 2007. These forms are used to request a favorable determination letter for an initial or ongoing ESOP. It appears that, about three years after the ESOP's January 1, 2004 effective date, Mr. Carpenter sought a determination letter from the IRS that the ESOP met the technical requirements of the tax law. The submission of these forms may have led to the IRS's audit of the ESOP for its 2004 tax year, because the no-change letter was issued about one year after that submission, on August 12, 2008.

[12] We note that while the IRS's letter was short, it did state that "during the examination [the IRS] noted certain items indicated on the enclosure, which require [OLI's] attention." However, appellant never submitted that enclosure as evidence in this appeal.

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supervising, and training MRRI's personnel, as well as formulating and submitting budgets, marketing plans, and operating goals for MRRI's business operations.

15. The agreement also provided that MRRI was required to pay OLI management fees totaling 25 percent of MRRI's monthly gross receipts, or an amount sufficient to meet OLI's current payroll, whichever was greater.

16. Based on the mailing address shown on both MRRI's and OLI's federal tax returns, as well as a notice provision in the agreement, it appears that for at least some of the years at issue, OLI's employment services were performed at the same business location that MRRI conducted its own business operations.

17. On its tax returns, MRRI deducted $15,342,666 of management fees purportedly paid to OLI from 2003 through 2006, as well as an additional $641,309 of administrative expenses in 2004, for a total of $15,983,975.[13] On average, these expenses roughly approximated 20 percent of MRRI's gross receipts, not the 25 percent amount required by the management agreement.

18. On its tax returns, OLI reported a total of $15,983,975 in management fees, which matched the corresponding fees and administrative expenses that MRRI deducted on its returns for the same tax years at issue. Thus, all of OLI's income came from MRRI.

19. For the years in dispute, OLI reported, in the aggregate, California taxable income of about $13 million, which included the management fee income, less certain deductions. It therefore paid the 1.5 percent, entity-level S corporation franchise or income tax on its net income. This income was passed through to OLI's owner, the ESOP, a tax-exempt entity that paid no tax on this income.

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[13] In a statement attached to support its "other deductions" on line 19 of its IRS Forms 1120S, MRRI deducted management fees of $1,000,000 in 2003, $5,016,421 in 2004, $6,476,161 in 2005, and $3,491,393 in 2006. In 2004, MRRI deducted, on line 19, administrative expenses of $641,309, which appear to have been paid to OLI. We also note that appellant provided a schedule listing management fees of $6,067,530 and $5,897,701 that MRRI purportedly paid to OLI in 2004 and 2005, respectively. However, because these amounts are inconsistent with the amounts that MRRI reported and deducted on its 2004 and 2005 tax returns, and appellant has not otherwise explained this inconsistency, we find them to be unreliable.

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Loans & Alleged Repayment With Real Property

20. According to its 2006 federal return, OLI appears to have made "loans" to MRRI totaling at least $5,404,858 since OLI's formation.[14] The funding for these loans came from the management fees MRRI allegedly paid to OLI.

21. According to a document dated May 25, 2010, entitled "Action by Unanimous Written Consent of the Board of Directors of Ocean, Living, Inc.," appellant purportedly transferred 29 parcels of residential real estate with equity totaling $11,236,777 to the ESOP or OLI on January 2, 2008, to repay the loans allegedly made "by the ESOP to Marshall Reddick via [MRRI]." This unanimous consent states that the loans had been made "to purchase investments for the [ESOP]." The unanimous consent was not signed by appellant, but rather by OLI's then sole director, Linda Gravani.

22. Appellant submitted schedules that he claims corroborate the fair market values of most of the 29 parcels of real estate allegedly transferred to OLI. The valuations listed are primarily from a third-party website, <www.zillow.com>. For the most part, they are based on estimates from the 2007 and 2008 years, which is the approximate timeframe when the parcels allegedly were transferred.

23. On these same schedules, appellant provided loan balances on the 29 parcels of real estate, some of which indicate high amounts of equity due to low outstanding loan balances on the properties. However, the record contains no documentary support, such as lender statements, for the loan balances.

24. Appellant also submitted real estate deed records showing he owned all or most of the subject real estate. However, the record contains no documentary evidence that appellant actually transferred any of the 29 parcels of real estate to the ESOP or OLI.

[14] The record does not contain documentation supporting the alleged existence of the loans and it is not clear when the loans originated, when MRRI received the proceeds, or what the terms and conditions of the loans were, such as the interest rate charged, if any. In fact, the identity of the parties to the loan is unclear from the documentation provided. Appellant's documentation at times refers to the ESOP, not OLI, as being the lender, and to appellant, not MRRI, as being the borrower. During the course of FTB's audit, appellant's prior representative submitted a letter to FTB indicating Mr. Carpenter had stated that the documentation for the loans had been destroyed by a fire that also destroyed appellant's accountant's office at some unspecified time.

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Life Insurance

25. Between November 2003 and December 2004, appellant acquired three whole life insurance policies with an aggregate death benefit of $77,734,288.[15] The policies listed appellant as the insured and OLI as the beneficiary.[16]

26. From 2004 through 2006, OLI paid life insurance premiums on behalf of appellant totaling $7,768,910.[17] As with the loans in question, the funds for these premiums came from the management fees MRRI allegedly paid to OLI.

27. In several documents entitled "Agreement as to Undivided Interests in a Universal Life Policy," appellant was listed as an initial 5 percent co-owner of the policies, with OLI owning the remaining 95 percent. However, based on an ownership formula, it appears OLI actually owned the policies because it, and not appellant in his individual capacity, paid all the premiums.

28. In early 2006, OLI borrowed at least $102,593 against the cash value of the life insurance policies.[18] Because appellant listed the tax identification number of OLI when he signed the document requesting the loan (apparently in his capacity as OLI's CEO), it seems the loan was disbursed directly to OLI and not to appellant personally.

Lawsuit Against the Promoter of the ESOP Strategy

29. On December 28, 2007, appellant and MRRI filed a lawsuit against the promoter of the ESOP strategy, ASRA Financial, Inc. (ASRA), as well as several other parties, some of whom were affiliated with ASRA.

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[15] One policy's benefit amount was $23,738,130 (effective November 28, 2003), the second was $6,000,000 (effective December 22, 2004), and the third was $47,996,158. We note that documentation for this third policy is not in the record but, in the briefing for this appeal, appellant claimed that OLI did purchase the policy.

[16] It appears OLI also held life insurance policies listing seven other employees as the insureds and paid life insurance premiums on behalf of those individuals. The evidence suggests that by March 2006, OLI stopped paying premiums on all of the life insurance policies it had purchased.

[17] On its tax returns, OLI reported it paid premiums of $1,155,242 in 2004, $4,762,637 in 2005, and $1,851,031 in 2006. These premiums were claimed as a deduction against OLI's book income for financial accounting purposes, but not against its taxable income for income tax purposes.

[18] The record does indicate that OLI borrowed a total of $595,851, which appears to include the $102,593, but these additional borrowings are not supported by any loan documentation.

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30. In the complaint, appellant and MRRI alleged that in late 2003, they sought the professional advice of ASRA and certain other defendants when they were in the process of attempting to establish an ESOP for the dual purpose of providing additional employee benefits and obtaining federal tax benefits.

31. After describing the ESOP structure and certain transactions at issue in this appeal, appellant and MRRI alleged the defendants knowingly sold them an ESOP strategy and life insurance policies that were "both patently illegal," did not comply with federal law, and exposed them to, among other things, "substantial adverse tax consequences."

32. As it relates to the issues in this appeal, appellant and MRRI alleged the following:

    a. Defendants convinced them to adopt a tax shelter strategy, whereby they would establish a new S corporation management company (which appears to be OLI), with an ESOP as its sole shareholder, and that by virtue of such ownership, the management company "would effectively be rendered tax-exempt."

    b. MRRI "would then pay large, tax deductible, management fees to the [S corporation management company], thereby shielding the amounts paid as management fees from taxation."

    c. The S corporation management company would purchase life insurance policies on appellant and key MRRI employees "using the management fees to fund such purchases, which policies would then be borrowed against by the employees with the loans to be repaid through policy proceeds upon the death of the beneficiary."

    d. The defendants' purpose of selling the ESOP strategy was to generate considerable commissions and income for the defendants at appellant's and MRRI's expense.

33. Appellant and MRRI also alleged the defendants' sale of insurance in connection with a defined benefit plan violated the Employee Retirement Income Security Act of 1974 (ERISA), Pub.L. 93–406, 88 Stat. 829, and exposed appellant and MRRI to large penalties. They claimed they had to take substantial steps and spend a considerable sum of money to remedy their violations of ERISA.

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34. Appellant testified that the lawsuit was eventually dismissed or settled, with MRRI receiving approximately $500,000 from the defendants.[19]

35. Sometime after the tax years in dispute, OLI went out of business. MRRI declared bankruptcy in 2009 and eventually dissolved, but at some point, appellant sold its assets to a few of his former employees, who now own and run the business.

Procedural History

36. On audit, FTB concluded the transactions among MRRI, OLI, and the ESOP (i.e., the management fees, loans, and life insurance policies) should be disregarded under the business purpose and economic substance doctrine. FTB determined that appellant formed OLI, created a management agreement between MRRI and OLI, and established the ESOP for the sole purpose of transferring taxable income from MRRI to a tax-exempt entity. FTB further determined that appellant caused OLI to accumulate MRRI's profits for his own benefit through the use of loans and life insurance policies.

37. Based on its findings, FTB collapsed the structure by reallocating OLI's net taxable income to appellant.[20] This reallocated income in effect permitted appellant to deduct all the expenses OLI had deducted, including deductions for officer compensation, salaries and wages.

38. FTB issued Notices of Proposed Assessment (NPAs) for the 2003 through 2006 tax years to appellant, all dated September 22, 2010.[21] The NPAs reflected, among other things, the above adjustment to appellant's taxable income, and assessed additional tax, the

[19] We note that this statement is contrary to appellant's briefs, in which appellant indicated the lawsuit was dismissed because it was a financial burden to him, and failed to disclose any recovery from the defendants.

[20] For example, for the 2005 and 2006 tax years, FTB reallocated $5,359,261 and $2,583,198, respectively, of OLI's California taxable income to appellant. Thus, through this income adjustment, FTB in effect disallowed a large portion of MRRI's management fee expense, increasing the income that flowed through to appellant from his wholly owned subchapter S corporation, MRRI.

[21] It appears the NPAs for the 2003 and 2004 tax years—and possibly for the 2005 tax year—were issued outside the normal four-year statute of limitations under R&TC section 19057. (The record does not reveal when appellant filed his 2005 California return.) However, because we conclude below that the transactions at issue in this appeal were shams, we find all the proposed assessments were timely issued within the extended eight-year statute of limitations for deficiencies related to abusive tax avoidance transactions under R&TC section 19755.

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NEST penalty,[22] and the IB penalty, plus interest. Appellant protested the NPAs, which FTB affirmed with Notices of Action.

39. Appellant timely filed an appeal with the BOE. On June 20, 2017, the BOE issued a summary decision deciding the appeal based on the written record, without an oral hearing. In its summary decision, the BOE sustained FTB's proposed assessments of tax and imposition of the NEST penalties for all the tax years at issue. The BOE also sustained the imposition of the IB penalties for the 2005 and 2006 tax years, but reversed them for the 2003 and 2004 tax years.[23] Appellant timely filed a petition for rehearing, on the ground that he had not been afforded the opportunity for an oral hearing. The BOE granted his petition.[24]

DISCUSSION

Issue 1 - Whether FTB erred in reallocating to appellant taxable income from OLI based on its determination that appellant's ESOP strategy lacked a nontax business purpose and economic substance, and therefore was a sham for the 2003 through 2006 tax years.

A. Burden of Proof

FTB's determination that the transaction is a sham is presumptively correct, and taxpayers have the burden of producing evidence to rebut the deficiency determination and the burden of persuasion to substantiate the deduction. (*Casebeer v. Commissioner* (9th Cir. 1990) 909 F.2d 1360, 1362, fn. 7 (*Casebeer*).) Unsupported assertions are insufficient to satisfy a taxpayer's burden of proof. (*Appeal of Aaron and Eloise Magidow*, 82-SBE-274, Nov. 17, 1982.)[25]

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[22] Each NPA also informed appellant that FTB would assert that the accuracy-related penalty under R&TC section 19164 should be imposed if the NEST penalty was not sustained.

[23] On rehearing, FTB has conceded that the IB penalties should not be imposed for the 2003 and 2004 tax years. However, whether the IB penalties for the 2005 and 2006 tax years were properly imposed is still in dispute.

[24] The Office of Tax Appeals has jurisdiction to hear and decide this matter under Cal. Code Regs., tit. 18, section 30106.

[25] BOE opinions are generally available for viewing on its website: <http://www.boe.ca.gov/legal/legalopcont.htm#boeopinion>.

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B. Applicable Law

1. General Overview of the Taxation of S Corporation ESOPs

California generally conforms to the federal income tax treatment of S corporations and their shareholders. (R&TC, § 23800; see also *Valentino v. Franchise Tax Bd.* (2001) 87 Cal.App.4th 1284 (*Valentino*).) An S corporation is a "small business corporation" for which a valid election has been made to be taxed under Subchapter S of Chapter 1 of the Internal Revenue Code (IRC). (IRC, § 1361(a)(1) & (b).) An S corporation generally does not pay federal income taxes at the entity level, and it pays California taxes on its income at a sharply reduced tax rate (of 1.5 percent). (Treas. Reg. § 1.1363-1; R&TC, § 23802.) For both federal and state tax purposes, the S corporation files an informational return each year reporting its gross income (or loss) and deductions, its shareholders, and the shareholders' pro rata shares of each item. (IRC, § 6037(a).) Those items are passed through on a pro rata basis to the shareholders, who report them on their personal income tax returns. (*Valentino*, *supra*, 87 Cal.App.4th at p. 1288.)

An employee stock ownership plan (i.e., ESOP) is a qualified retirement plan designed to invest primarily in the employer's securities, and, thus, provide the participants with an ownership interest in their employer. (See Kaplan, Brown, and Turley, *ESOPs*, 354-9th Tax Management Portfolio (BNA), I.) ESOPs are a type of tax-exempt entity, and their taxation is generally governed by IRC sections 401(a) and 4975(e)(7), as well as other relevant provisions of the IRC, related treasury regulations, and IRS administrative guidance. (See *Weekend Warrior Trailers, Inc. v. Commissioner*, T.C. Memo. 2011-105, 2011 WL 1900159 at *14 (*Weekend Warrior*).) California generally conforms to the federal income tax treatment of ESOPs. (See R&TC, § 17501(a).)

In 1996, the U.S. Congress expanded the definition of a small business corporation to allow certain tax-exempt entities, including ESOPs, to be eligible shareholders of an S corporation. (IRC, § 1361(c)(6); see *Weekend Warrior, supra,* 2011 WL 1900159 at *14.) In doing so, Congress intended to encourage employee ownership of closely-held businesses and to facilitate the establishment of ESOPs by S corporations. (See *Weekend Warrior, supra,* 2011 WL 1900159 at *14.)

Under the 1996 amendments, to the extent an S corporation is owned by an ESOP, the S corporation's income generally will be exempt from federal income tax at both the S corporation

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and ESOP shareholder level. (See *Weekend Warrior, supra,* 2011 WL 1900159 at *14.) Moreover, income allocable to an ESOP from an S corporation does not constitute "unrelated business taxable income" under IRC sections 512(a)(1) and (e)(3). (See *Austin v. Commissioner,* T.C. Memo. 2017-69, 2017 WL 1437879 at *12 (*Austin*).) Because California generally conforms to the federal income tax treatment, an S corporation's income will also be exempt from tax at the ESOP shareholder level for California tax purposes.[26]

In this appeal, the parties do not dispute whether the ESOP strategy complied with the letter of the tax law and the FTB does not contend that the strategy was a listed transaction for federal tax purposes. The FTB also does not contend that the ESOP, OLI, or MRRI were sham entities. Rather, the dispute centers on whether the transactions engaged in with respect to that strategy (i.e., the management fees and the loans) were shams, and therefore should be disregarded for California tax purposes.

2. Sham Transactions Generally

In general, a transaction will be respected for tax purposes if it has "economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached." (*Frank Lyon Co. v. United States* (1978) 435 U.S. 561, 583-584.) In contrast, it is a well-settled tax law principle that a transaction with no economic effects, in which the underlying documents are a device to conceal its true purpose, does not control the incidence of taxes. (*Sacks v. Commissioner* (9th Cir. 1995) 69 F.3d 982, 986.) Therefore, the courts have long recognized "the importance of regarding matters of substance and disregarding forms ...." (*United States v. Phellis* (1921) 257 U.S. 156, 168.) This is because "[t]he incidence of taxation depends upon the substance of a transaction." (*Commissioner v. Court Holding Co.* (1945) 324 U.S. 331, 334.)

Federal circuit courts have developed a variety of approaches when applying the sham transaction doctrine. As relevant here, the Ninth Circuit Court of Appeals has adopted an approach that considers both subjective and objective factors in characterizing a transaction for tax purposes. (*Casebeer, supra,* 909 F.2d at pp. 1362-63.) Specifically, the Ninth Circuit applies

[26] However, although California conforms to the federal pass-through treatment, it still subjects S corporations to an entity-level tax at a 1.5 percent tax rate. (R&TC, § 23802(b).) Thus, unlike the federal tax treatment, for California tax purposes an S corporation's income will not entirely escape taxation at the entity level, even if the S corporation is owned by an ESOP.

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"a two-part test for determining whether a transaction is a sham: 1) has the taxpayer shown that it had a business purpose for engaging in the transaction other than tax avoidance? 2) has the taxpayer shown that the transaction had economic substance beyond the creation of tax benefits?" (*Id.* at p. 1363, internal quotations and citation omitted; see also *Appeal of James A. Alyn and Lisa E. Alyn*, 2009-SBE-001, May 27, 2009 [wherein the BOE adopted this two-part inquiry].)

The application of the "business purpose" prong is a subjective test, whereas the application of the "economic substance" prong is an objective test. (*Sochin v. Commissioner* (9th Cir. 1988) 843 F.2d 351, 354.) This two-prong focus is not a conjunctive test nor a "rigid two-step analysis." (*Casebeer*, *supra*, 909 F.2d at p. 1363.) Instead, the two prongs (or tests) are "precise factors" that are weighed to determine whether the transaction had any practical economic effects other than the creation of tax losses. (*Ibid.*) Whether the taxpayer meets the business purpose or economic substance test is a factual determination. (*Id.* at pp. 1363, 1365.)

We next apply the two-prong sham transaction analysis to determine whether the transactions between MRRI, OLI, and the ESOP had any practical economic effects other than tax benefits. In doing so, we examine whether appellant has shown (1) a subjective business purpose for entering into the transactions, and (2) the objective economic substance of the transactions.

C. Analysis & Conclusion

1. The Business Purpose Test

Under the business purpose test, it must be determined whether the taxpayer had a business purpose for engaging in the transaction other than tax avoidance. (*Casebeer*, *supra*, 909 F.2d at p. 1363.) This test often involves an examination of the subjective factors that motivated a taxpayer to make the transaction at issue. (*Ibid.*) However, a taxpayer's subjective motive is determined by examining the objective evidence. (*Austin, supra,* 2017 WL 1437879 at *14.) A taxpayer may demonstrate a valid business purpose by showing the transaction was rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and economic situation. (*Ibid.*)

Appellant's primary contention is that he formed OLI, an ESOP-owned S corporation, to reward MRRI's former rank-and-file employees by creating and maintaining a substantial

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qualified pension fund. He asserts that had the real estate market not collapsed shortly after the years in dispute, the ESOP pension would have been fully funded and there would have been no dispute with FTB.

We disagree. Instead, we find the subject transactions of the tax scheme (i.e., the management fees and circular money flow through loans) were shams that lacked any kind of business purpose other than to save appellant taxes. We address each of these related transactions in turn.

The ESOP scheme began with and effectively centered around the management fee arrangement. Appellant contends the management fee arrangement was entered into to allow OLI to earn income and give value to the ESOP. According to appellant, the fees benefited OLI's rank-and-file employees and not him, because he was not a participant in the ESOP.

We find no merit to these contentions. Rather, it is clear that the sole purpose of the management fee arrangement was to generate large tax deductions, as appellant admitted in his lawsuit against the tax shelter promoter. From the outset, we believe the management agreement—wherein MRRI allegedly paid OLI a total of $15,983,975 for purported management and administrative services—was a sham itself and therefore lacked business substance. In fact, there was no written management agreement in place during the tax years on appeal. Appellant only produced one document purporting to be the management agreement between MRRI and OLI, and it became effective in 2009, after the appeal years. Even if the 2009 agreement were meant to cover services for the appeal years, we question whether they were performed by OLI's employees because, again, no evidence was ever produced to substantiate this assertion.

Revealingly, MRRI paid management fees of $1 million to OLI for its first taxable year in 2003, a short tax year covering less than two weeks, even though the ESOP plan's effective date was not until the next year, January 1, 2004. These facts suggest that no management services were performed in 2003, because the ESOP did not have any employee participants, and therefore was not active, until 2004, at the earliest. When asked about this at the oral hearing, appellant essentially conceded that the 2003 fee was improper and should be disallowed. We believe this also casts doubt on whether the ESOP, without any participants, could have been a shareholder of OLI in 2003, as well as the credibility and effectiveness of the initial agreements setting up the structure in December 2003.

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We also find that the management fees were unjustifiably high.[27] On average, these fees roughly approximated 20 percent of MRRI's gross receipts for each year at issue. Yet, these fees were less than the amount required under the management fee agreement, which obligated MRRI to pay OLI fees totaling 25 percent of MRRI's monthly gross receipts, or an amount sufficient to meet OLI's current payroll, whichever was greater. There is no documentation in the record addressing whether the fees were reasonably priced or whether MRRI and OLI dealt with each other as unrelated third-parties; i.e., at arm's length. Indeed, the fact that OLI immediately "loaned back" significant portions of the management fees indicates to us that MRRI was financially unable to pay the full amount of its fee obligation. The fees also appear to be unreasonably high when one takes into account the fact that the services allegedly performed by OLI (by former MMRI employees) cost MRRI far more in management fees than the expenses it would have incurred had it continued to provide those services for itself. For example, in 2003, MRRI deducted a $1 million management fee for OLI's services. However, OLI's tax return reveals OLI incurred only $10,900 of deductible expenses in allegedly providing those services. For 2004, 2005, and 2006, MRRI paid OLI management fees of $5,016,421, $6,476,161 and $3,491,393, respectively; OLI, however, reported that it incurred deductible expenses of just $1,377,762, $1,069,635 and $1,138,986, respectively, in providing services to MRRI for those years. If MRRI had not transferred its employees to OLI and kept them in-house, it would have saved itself approximately $12.4 million.

Accordingly, we conclude the management fees were set at an unreasonably high (and seemingly arbitrary) level for the sole purpose of reducing MRRI's and appellant's tax liabilities. Therefore, all these facts, taken together, establish that the fee arrangement is properly treated as a sham transaction.

Like the related management fees, the loans—in which OLI lent money to MRRI—were also shams. MRRI, which appellant fully controlled, received a large portion of the $15,983,975 in management fees back (i.e., $5,404,858, or about 34 percent) in the form of loans to allegedly used to fund MRRI's real estate operations.[28] However, the evidence does not show how these

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[27] We even question how much in claimed fees, if any, MRRI actually paid to OLI. In this regard, we note that appellant's schedule listing management fees MRRI purportedly paid to OLI in 2004 and 2005 is inconsistent with the amounts MRRI reported and deducted on its returns for those same years.

[28] Indeed, in 2003, after MRRI paid OLI $1 million in fees, OLI lent most of that money (i.e., $990,000) right back to MRRI, according OLI's 2003 IRS Form 1120S.

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loans benefited the ESOP, such as through additional MRRI profits inuring to the benefit of the ESOP's retirement pension fund. There also is no contemporaneous documentary evidence of the loans (it was allegedly destroyed by a fire), or proof that the loans were ever repaid (as addressed below). Moreover, it is not clear why, other than to obtain a large tax deduction, MRRI paid exorbitant amounts for management fees when it needed to immediately borrow back a significant portion of the amounts paid to operate its business.

As with the management fees and loans, we further conclude the life insurance policy transactions lacked a nontax business purpose. In addition to using the fees to fund the issuance of loans to MRRI, OLI used a substantial portion of these fees (i.e., $7,768,910, or about 49 percent) to pay premiums on life insurance policies covering appellant's and certain other employees' lives. Appellant contends the purpose of the policies was to provide "security" that the ESOP would receive funds to benefit OLI's employees. According to appellant, the ESOP was "secured" because if the insured employees had died, the ESOP would receive significant insurance proceeds. Again, we disagree because the facts do not support this contention.

Most significantly, the policies provided no security whatsoever for the ESOP, because there was no obligation on anyone (appellant, MRRI or OLI) to continue paying premiums on these policies. In fact, by early 2006, OLI decided to stop making payments on these policies. Based on the allegations in the lawsuit against the promoter, we find the purpose of the arrangement was so appellant could access the cash value of those policies in a tax-free manner. There is no credible evidence indicating the life insurance had anything to do with benefiting the ESOP or its participants.

In short, of the $15,983,975 management fees that was purportedly paid for the benefit of the ESOP, appellant and/or MRRI received about 34 percent of that amount back in the form of loans, and 49 percent went to purchase life insurance policies that appellant intended to use as a source for additional loans. In stark contrast, the employee participants of the ESOP received very little from the ESOP's ownership of OLI. OLI's balance sheets from its 2003 through 2006 tax returns showed insignificant assets, with cash only in the tens of thousands of dollars. While OLI did have other assets valued in the millions, they were simply receivables due from MRRI for the management fees and loans.[29] Accordingly, we find the tax scheme was intended to

[29] For these reasons, we also find OLI's independent business valuation and appraisal reports for 2004 and 2005 to be unreliable because they are contradicted by other evidence we find credible.

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generate a bogus management fee deduction primarily, if not solely, to benefit appellant and reduce his taxes.[30] We next address and reject appellant's other contentions.

Appellant contends that to comply with federal requirements and assure he did not personally benefit from the newly-created benefit program, the ESOP needed to exist separately from MRRI. Therefore, appellant argues, he had to create OLI to sponsor the ESOP. In substance, appellant appears to be arguing that he could not retain control of MRRI and, at the same time, establish an ESOP to own MRRI, because his controlling interests in MRRI would have disqualified the ESOP from being tax-exempt, as it would not have primarily benefited MRRI's rank-and-file employees. (See, e.g., IRC, § 409(p) [prohibiting an ESOP holding shares in a S corporation from benefitting any person deemed to own a certain percent of the corporation's shares, effective for plan years ending after March 14, 2001, for ESOPs created after that date, such as the ESOP here].)

However, we question why appellant needed to restructure his business other than to avoid taxes. We note that, given appellant's stated business purpose to benefit all of MRRI's employees, it is unclear why MRRI did not transfer all of them to OLI, so that they, too, could participate in the ESOP.

Appellant also claimed in his brief that "OLI [was] an entity unrelated to and unaffiliated with [himself]." However, we find appellant, in substance, controlled OLI and its ESOP and used the structure to obtain tax benefits primarily, if not solely, for himself, as discussed above. The documentary evidence shows that for the years under review, not only was appellant heavily involved in OLI and its ESOP, but he also appears to have been the only individual making any substantive management decisions.[31] Appellant served as OLI's CEO and testified he ran its day-to-day operations for which he was compensated with a substantial salary. He also signed OLI's tax returns and checks, and many of the agreements implementing the ESOP scheme. He served as the trustee of OLI's ESOP. We further find appellant's assertion that he had nothing to

[30] We also reject appellant's contention that some benefits were paid to vested members of the ESOP. We find no proof of that claim, other than one unsubstantiated, undated, and unsigned (rather brief) email. That email—which appears to have been copied and pasted into appellant's briefs from his own email account—is from an employee named Barbara to appellant, wherein she alleges she received a check from the ESOP, was "very grateful," and "[i]t was a good program for [her] that [appellant] started." Given the contrary evidence in the record, and the lack of specificity of Barbara's email, we do not find Barbara's statements to constitute credible evidence that the ESOP benefitted its participants.

[31] Although appellant asserted that OLI was managed by a three-person management team, we reject this contention as it is unsupported by any documentary evidence.

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do with the decision to make the loans or purchase life insurance policies to not be credible. Simply stated, to ensure the tax scheme he himself set up was properly implemented and carried out as intended, appellant could not be completely dissociated from OLI or its ESOP. Accordingly, we find appellant has not shown he had a business purpose for engaging in the transactions other than tax avoidance.

2. The Economic Substance Test

Under the economic substance test, one examines whether the transaction had economic substance beyond the creation of tax benefits. (*Casebeer*, *supra*, 909 F.2d at p. 1365.) This test involves a broad examination of whether the substance of a transaction reflects its form, and whether, from an objective standpoint, the transaction was likely to produce economic benefits aside from a tax deduction. (*Ibid.*)

Here, the evidence shows there was no economic substance to the transactions under review. The circular flow of funds all started with the $15,983,975 in fees MRRI allegedly paid to OLI for management services. However, OLI, which appellant effectively controlled, sent 34 percent of these fees right back to appellant and/or MRRI through the use of loans. Thus, not only did appellant generate large tax deductions by purportedly paying management fees, but, at the same time, he also effectively held onto a substantial portion of that cash for uses wholly unrelated to benefiting the employee participants of the ESOP. In addition, as discussed above, OLI used 49 percent of the fees to purchase life insurance policies that appellant intended to use as a source for additional loans. Therefore, at least 83 percent of the fees never went to the ESOP.[32] The ESOP itself, in contrast, received relatively little cash and assets from the arrangement.[33]

Appellant disagrees, contending he was in fact economically impacted because he transferred real property to the ESOP (or to OLI) to pay off the loans of $5,404,858. However, appellant has not provided evidence to support this assertion. The deeds provided by appellant do not show any real property transfers from appellant or MRRI to the ESOP or to OLI. Rather,

[32] It appears the remaining 17 percent simply went to pay OLI's business expenses.

[33] Cf. *Austin, supra,* 2017 WL 1437879 at *12 [holding that the formation and maintenance of an S corporation ESOP had economic substance and a served a legitimate business purpose, in part, because the ESOP's assets grew in value from $500,000 to $10.4 million, and, when its stock was redeemed, about $9.1 million inured to the benefit of the ESOP participants].

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all they show, if anything, is that appellant owned most or all the properties, not that he transferred ownership of them to the ESOP or OLI. In addition, even if there were some transfers, the purported real property valuations are not supported by any neutral evaluation of the properties' fair market values. There is also no support that the equity values were as high as appellant himself unilaterally determined because he never submitted documentation corroborating the purported low amounts of debt on the properties. Unsupported assertions are insufficient to satisfy a taxpayer's burden of proof. (*Appeal of Aaron and Eloise Magidow, supra*.) Accordingly, we find no evidence in the record that appellant's economic position substantially changed, if at all, other than by generating large tax deductions.

Appellant also asserts that, according to a letter dated August 12, 2008, the IRS examined the ESOP in question for the 2004 tax year and did not invalidate it and therefore we should find in his favor here. Appellant's assertion is misplaced. The IRS was only addressing whether the ESOP was valid from a technical standpoint. It therefore did not review, as we are doing here, whether certain transactions are shams that should be disregarded.[34] Indeed, in *Weekend Warrior*, *supra*, the court upheld the IRS's determination that the ESOP management fee transactions were a sham even though the IRS had "determined that the retirement plan and related trust were designed in accordance with the applicable sections of the [Internal Revenue] Code." (*Weekend Warrior, supra,* 2011 WL 1900159 at *9.) In any event, we are not bound by IRS determinations when we find the evidence in the record demonstrates otherwise. (See, e.g., *Appeal of Der Wienerschnitzel International, Inc.*, 79-SBE-063, Apr. 10, 1979.)

Lastly, appellant argues that if we find the ESOP scheme to be a sham, FTB's reallocation of OLI's taxable income to him should be reduced by OLI's payroll and related expenses. Appellant essentially asserts the management fees were reimbursement for OLI's payroll expense, and that had MRRI kept these employees itself, it would have been entitled to

[34] Appellant also never submitted the enclosure to the IRS's no-change letter that listed deficiencies in the ESOP arrangement that the IRS recommended be fixed. At the oral hearing, he stated that some of the changes requested by the IRS to make the plan acceptable were not undertaken subsequent to the letter, other than (presumably) the IRS's recommendation that he resign as OLI's CEO. In any event, without that enclosure, we are unable to determine exactly what the IRS concluded, but seriously doubt it conducted an examination of the transactions we are reviewing.

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deduct such expenses. We find no merit to this argument because OLI's reallocated taxable income already includes a deduction for these expenses, which are reflected in FTB's NPAs.[35]

In sum, we conclude the ESOP strategy was a sham that lacked a nontax business purpose and economic substance.

Issue 2 – Whether FTB properly imposed the NEST penalty for the 2003 through 2006 tax years.

R&TC section 19774(a) imposes a penalty for a noneconomic substance transaction (i.e., NEST) understatement for any taxable year in an amount equal to 40 percent of the amount of the understatement. The penalty is reduced to 20 percent with respect to the portion of any NEST understatement if the relevant facts affecting the tax treatment of the item were adequately disclosed in the return or a statement attached to the return. (R&TC, § 19774(b)(1).)

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

(R&TC, § 19774(c)(2)(A).)

If an NPA has been issued that imposes the NEST penalty, only FTB's Chief Counsel may compromise all or any portion of that penalty. (R&TC, § 19774(d)(1).) In addition, notwithstanding any other law or rule of law, the Chief Counsel's determination may not be reviewed in any administrative or judicial proceeding. (R&TC, § 19774(d)(3).) Thus, we are precluded by statute from abating the NEST penalty or reviewing any decision of FTB's Chief Counsel denying any request by appellant for abatement of the penalty. Our limited role,

[35] We emphasize that FTB's reallocation to appellant of OLI's taxable income, which essentially consists of the management fee income less deductible expenses (i.e., a net amount), is more favorable to appellant than had FTB simply disallowed MRRI's management fee expense in full, without allowing it to be offset by expenses.

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therefore, is simply to determine whether the NEST penalty was properly imposed in the first place.

As concluded above, we find the ESOP arrangement was a sham. The transactions lacked economic substance and appellant did not have a valid nontax business purpose for entering into the transactions. In addition, appellant does not contend, and the facts do not show, that he adequately disclosed the relevant facts affecting the tax treatment of these transactions in his 2003 through 2006 tax returns or in a statement attached to those returns. Accordingly, FTB properly imposed the 40 percent NEST penalty for each year.[36]

<u>Issue 3 – Whether FTB properly imposed the IB penalty for the 2005 and 2006 tax years</u>.

R&TC section 19777(a) imposes an interest-based (IB) penalty in the amount of 100 percent of the interest payable under R&TC section 19101 for the period beginning on the last date prescribed by law for the payment of that tax (determined without regard to extensions) and ending on the date the NPA is mailed.[37] The IB penalty applies if a taxpayer has a deficiency and has been contacted by FTB about, as relevant here, a "gross misstatement" within the meaning of IRC section 6404(g)(2)(D).[38]

As relevant here, Treasury Regulation section 301.6404-4(b)(4)(A) defines a gross misstatement as "a substantial omission of income as described in [IRC] section 6501(e)(1)." IRC section 6501(e)(1)(A)(i) in turn defines a "substantial omission" of gross income as an "amount [that] is in excess of 25 percent of the amount of gross income stated in the return ...." In determining whether this 25 percent omission test has been met, in the case of a trade or business, "gross income" means "the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services." (IRC, § 6501(e)(1)(B)(i).) For this purpose, where a

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[36] Because we sustain the NEST penalty, we do not need address FTB's alternative position that appellant is liable for the accuracy-related penalty under R&TC section 19164.

[37] Note that R&TC section 19777 has been amended several times. Therefore, we are applying the version of R&TC section 19777 that was effective October 7, 2005, to March 23, 2011, and applicable to NPAs mailed before March 24, 2011, because the 2005 and 2006 NPAs here were issued on September 22, 2010. (See Stats. 2005, ch. 691, § 50.7.)

[38] R&TC section 19777 also applies to a reportable transaction, as defined in IRC section 6707A(c)(1) with respect to which the requirements of IRC section 6664(d)(2)(A) are not met, as well as any listed transaction, as defined in IRC section 6707A(c)(2). As argued at the oral hearing, FTB is only asserting the IB penalty was properly imposed based on a gross misstatement.

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taxpayer's personal income tax return reports a distributive share of income from a pass-through entity, such as a S corporation, the computation of gross income includes the taxpayer's distributive share of the gross receipts reported on the pass-through entity's return. (See *Hoffman v. Commissioner* (2002) 119 T.C. 140, 148-150.)

Here, for the 2005 and 2006 tax years, the omitted gross income reallocated to appellant does *not* exceed 25 percent of the gross income stated in appellant's California returns when one takes into account his distributive share of MRRI's gross income. For 2005, appellant's omitted gross income is $6,476,161. In determining whether this amount is a "substantial omission" of more than 25 percent of appellant's reported gross income amount, his 100 percent distributive share of MRRI's reported gross income is included in the computation (because he was its sole shareholder). Therefore, it becomes clear that the omitted income is not a substantial omission because the omitted income amount does not exceed 25 percent of MRRI's reported gross income (i.e., $6,476,161 / $25,949,548 <25%), even before taking into account the other gross income (not from MRRI) appellant reported on his Form 540. For 2006, the result is the same. Appellant's omitted gross income is $3,491,393, and his distributive share of the reported gross income of MRRI is $23,275,952 ($3,491,393 / $23,275,952 < 25%). Accordingly, FTB improperly imposed the IB penalty for the 2005 and 2006 tax years.

HOLDINGS

1. FTB did not err in reallocating to appellant taxable income from OLI based on its determination that appellant's ESOP strategy lacked a nontax business purpose and economic substance, and therefore was a sham for the 2003 through 2006 tax years.
2. FTB properly imposed the NEST penalty for the 2003 through 2006 tax years.
3. FTB improperly imposed the IB penalty for the 2005 and 2006 tax years.

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DISPOSITION

FTB's actions are sustained, except the IB penalty for the 2003 through 2006 tax years shall be eliminated from FTB's proposed assessments.

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Kenneth Gast
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Kenneth Gast
Administrative Law Judge

We concur:

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