DocuSign Envelope ID: 65D843C6-1B64-4806-945E-00D3A2E331A0

2019 – OTA – 321
Nonprecedential

**OFFICE OF TAX APPEALS**

**STATE OF CALIFORNIA**

| In the Matter of the Appeal of: | ) OTA Case No. 18042809 |
|---|---|
| **TOO FUN DESIGNS** | ) Date Issued: October 14, 2019 |

# OPINION

Representing the Parties:

For Appellant: Kimberly Beshears

For Respondent: Joel Smith, Tax Counsel

J. MARGOLIS, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19324, appellant Too Fun Designs (TFD) appeals an action by respondent Franchise Tax Board (FTB) denying TFD's claim for refund of a $432 partnership late-filing penalty assessed under R&TC section 19172.

TFD waived its right to an oral hearing; therefore, this matter is being decided based on the written record.

## ISSUE

Whether TFD is liable for the partnership late-filing penalty assessed and paid for tax year 2015.

## FACTUAL FINDINGS

1. TFD is a California partnership consisting of two partners. It was formed and commenced business on March 1, 2015. One of TFD's partners was Kimberly Beshears.
2. TFD filed its 2015 California return (Form 565) late, on or about April 5, 2017. TFD's California return reported gross receipts or sales of $382, cost of goods sold of $441, and other deductions of $118, resulting in a loss for tax purposes of $177.

DocuSign Envelope ID: 65D843C6-1B64-4806-945E-00D3A2E331A0

3. According to TFD's return, TFD's principal product or service was "arts & crafts." TFD sold handmade crocheted items to Ms. Beshears' family and friends, and to the general public at craft fairs.
4. FTB accepted TFD's return as filed. However, because TFD's return was filed late, FTB issued a Notice of Balance Due to TFD on October 20, 2017, imposing a $432 partnership late-filing penalty pursuant to R&TC section 19172.
5. TFD promptly paid the penalty and submitted a claim for refund of the amount paid. In the claim, Ms. Beshears stated that she was new to owning and operating a business when she formed TFD and did not realize she had an obligation to file partnership tax returns for TFD until she attended a Small Business Association meeting on taxation law. Before that time, she believed TFD was not required to file a partnership return because TFD did not itself owe taxes (since it was a pass-through entity) and it lost money.

   Ms. Beshears also stated that she had communicated with the Internal Revenue Service (IRS) with respect to TFD's unfiled 2015 and 2016 federal partnership returns, and that the IRS had agreed to waive the late-filing penalties it had proposed against TFD for 2015 and 2016. TFD produced two letters from the IRS in support. An IRS letter concerning TFD's 2015 tax year, dated June 13, 2017, states that the IRS had abated the federal late-filing penalty for 2015,

   > . . . because you have a good history of filing and paying on time. This type of penalty removal is only available one time. We will base our decision to remove any future penalties on reasonable cause criteria.

   An IRS letter concerning TFD's 2016 year, dated July 18, 2107, states as follows:

   > We are removing the penalty for filing a late or incomplete partnership return based on your statement that you qualify for penalty relief under Revenue Procedure 84-35 (applicable to partnerships with 10 or fewer partners). We will reassess the penalty if we later find that you don't qualify for relief because of any of the following reasons:
   >
   > * Any partner is not a natural person or the estate of a natural person.
   >
   > * The partnership elected to be subject to the rules for consolidated audit proceedings under IRC [Internal Revenue Code] sections 6221 through 6234.

DocuSign Envelope ID: 65D843C6-1B64-4806-945E-00D3A2E331A0

> * Any partner filed late or failed to report his or her distributive share of partnership items on his or her income tax return.

6. After FTB denied the TFD's refund claim, TFD filed this timely appeal.
7. In TFD's appeal letter, Ms. Beshears explained that TFD was just a vehicle she formed to pursue her crocheting hobby, and that she only applied for a small business license for TFD because she thought one was required in order to obtain a seller's permit so that she could sell her crocheted items at craft fairs. She stated:

> [P]lease note that I did not claim any write off amounts for my individual taxes. If you review my individual tax filings, you will see that I have always been fiscally responsible and timely. A note of interest for consideration: The IRS has forgiven my lack of knowledge regarding tax filing requirements [u]nder Revenue Procedure 84-35 along with my good history of filing and paying on time and issued a full refund. I find it hard to believe that the Franchise Tax Board would not extend the same courtesy or are not utilizing similar methods of determining appeal outcomes. My actions were not an attempt to escape paying taxes as there were none due.

8. The Office of Tax Appeals requested additional briefing from the parties concerning the applicability of IRS Revenue Procedure (Rev. Proc.) 84-35 and IRS Chief Counsel Memorandum No. 201733013 (released August 18, 2017) to TFD's position. FTB submitted a supplemental brief alleging that those rulings were inapplicable for California purposes because they arise out of the small partnership provisions of federal law, Internal Revenue Code (IRC) section 6231(a)(1)(B), to which California does not conform. TFD did not respond.

## DISCUSSION

Although general partnerships are not subject to California income tax, they are required to file "information returns" (Forms 565) reporting their income and to issue Schedules K-1 (565) to their partners. (R&TC, § 18633.) TFD was obligated to file a 2015 California return but failed to timely file.

When a partnership required to file a California return fails to timely file, a late-filing penalty under R&TC section 19172 shall be imposed "unless it is shown that the failure is due to

DocuSign Envelope ID: 65D843C6-1B64-4806-945E-00D3A2E331A0

reasonable cause."[1] (R&TC, § 19172(a)(2).) TFD promptly paid the penalty and filed a claim for refund.

In its claim for refund and subsequent appeal from FTB's denial thereof, TFD alleges that reasonable cause exists for the late filing because:

(1) TFD was just a hobby, not a business;
(2) TFD generated losses, not income, and its losses were not deducted by its partners;[2] and
(3) the IRS abated the federal partnership late-filing penalties that it originally sought to impose against TFD for the years 2015 and 2016. Because the California partnership late-filing penalty is modeled on the federal late-filing penalty provision, TFD "find[s] it hard to believe that the Franchise Tax Board would not extend the same courtesy or are not utilizing similar methods of determining appeal outcomes."

The fact that TFD was viewed as a hobby and not as a business by Ms. Beshears does not abrogate the requirement that TFD file a California tax return. Neither does the fact that TFD's partners did not deduct the losses generated by TFD.

However, it is significant that the IRS abated the federal late-filing penalties it had proposed against TFD for the years 2015 and 2016 because federal determinations are rebuttably presumed to be correct, where, as here, the state statute upon which the state's determination is premised is modeled on a federal statute. "Our Legislature has generally followed the federal statutes in designing California's personal income tax system, making federal decisions interpreting substantially identical statutes unusually strong persuasive precedent on construction of our own laws." (*People v. Hagen* (1998) 19 Cal.4th 652, 661; see also *Calhoun v. Franchise Tax Bd.* (1978) 20 Cal.3d 881.) "In instances where federal law and California law are the same, . . . rulings and regulations dealing with the IRC are persuasive authority in interpreting the California statute." (*J. H. McKnight Ranch, Inc. v. Franchise Tax Bd.* (2003) 110 Cal.App.4th

---

[1] The penalty is calculated at $18 for each month the return is late, not to exceed 12 months, multiplied by the number of partners in the partnership. Because TFD had two partners and its return was considered 12 months late for purposes of calculating the late-filing penalty, the FTB assessed a $432 penalty against TFD ($18 x 12 months x 2 partners = $432).

[2] Although Ms. Beshears alleges only that she did not claim the losses from TFD, we presume TFD's other partner did not claim more losses from the partnership than were reported on Schedule K-1 (565).

DocuSign Envelope ID: 65D843C6-1B64-4806-945E-00D3A2E331A0

978, 984, fn. 1.) "The obvious parallelism of the federal and state statutes . . . requires that one wishing to comply with the state provision look to the federal counterpart for guidance." (*Spurgeon v. Franchise Tax Bd.* (1984) 160 Cal.App.3d 524, 530.) "This policy makes available to the state a ground work of relevant federal experience and judicial pronouncements." (*Holmes v. McColgan* (1941) 17 Cal.2d 426, 430; see also *Rihn v. Franchise Tax Bd.* (1955) 131 Cal.App.2d 356, 360.)

There is no dispute that the federal per partner late-filing penalty, IRC section 6698, enacted in 1978,[3] was the basis for California's per partner late-filing penalty, R&TC section 19172, which was enacted in 1983 as former R&TC section 18681.2.[4] Included in the legislative history file pertaining to the enactment of the state's per partner late-filing penalty is a conformity "Task Force Team" report containing a recommendation for "routine conformity [with IRC section 6698] with the state penalty at $10 [it has since been increased to $18] multiplied by the number of partners (20% of the federal amount)."

The IRS abated the 2015 penalty originally proposed against TFD because of its First Time Abate program, and the 2016 penalty pursuant to the provisions of Rev. Proc. 84-35, 1984-1 C.B. 509. Under the IRS's First Time Abate program, the IRS abates first-time timeliness penalties if a taxpayer has timely filed returns and paid taxes due for the preceding three years. However, FTB has not adopted a similar program, and nothing in the penalty statute itself, or the underlying legislative history, suggests that the penalty's reasonable cause exception should be interpreted as granting each taxpayer one "free pass." Furthermore, the California Legislature has considered and declined to adopt bills that would have allowed a first-time abatement for taxpayers with a history of filing and payment compliance. (See, e.g., Assem. Bill No. 1777 (2013-2014 Reg. Sess.).) Accordingly, we lack the authority to extend the IRS's First Time Abate policy to California taxpayers.

---

[3] See the Revenue Act of 1978 (Pub.L. 95-600, 92 Stat. 2763, § 171 (Nov. 6, 1978)).

[4] See Assem. Bill No. 399, Stats. 1983, ch. 498, § 150. An "item-by-item analysis" contained in the legislative history file pertaining to A.B. 399 that is maintained by the California State Archives also confirms the California per partner late-filing penalty was based IRC section 6698.

DocuSign Envelope ID: 65D843C6-1B64-4806-945E-00D3A2E331A0

The situation is different, however, with respect to the IRS's application of Rev. Proc. 84-35 to abate the late-filing penalty imposed against TFD.[5] "Although Revenue Procedures are not given the effect of Treasury Regulations, . . . they are official statements of the IRS on procedural matters and are published to promote uniform application of the Internal Revenue Laws." (*Dillon, Read & Co., Inc. v. United States* (Fed. Cir. 1989) 875 F.2d 293, 299; see also 26 C.F.R. § 601(d)(2)(i)(b).) Rev. Proc. 84-35 was promulgated in 1984 to update, modify, and supersede an earlier IRS ruling, Rev. Proc. 81-11, 1981-1 C.B. 651. Both rulings deal with the same subject matter and accomplish the same result. Rev. Proc. 81-11 "set[s] forth the procedures under which partnerships with ten or fewer partners will not be subject to the penalty imposed by section 6698 of the Internal Revenue Code for the failure to file a partnership return." (Rev. Proc. 81-11, at § 1.) Rev. Proc. 84-35 states that its purpose was "to update Rev. Proc. 81-11, 1981-1 C.B. 651, to conform to the small partnership provisions of section 6231(a)(1)(B) of the Internal Revenue Code." (Rev. Proc. 84-35, at § 1.)

Both rulings are premised upon the Congressional legislative history underlying IRC section 6698. That legislative history makes clear that Congress intended that the reasonable cause exception contained in IRC section 6698 should be interpreted broadly so as to apply to smaller partnerships whose partners properly reported their shares of partnership income on their individual returns:

> The penalty will not be imposed if the partnership can show reasonable cause for failure to file a complete or timely return. Smaller partnerships (those with 10 or fewer partners) will not be subject to the penalty under this reasonable cause test so long as each partner fully reports his share of the income, deductions, and credits of the partnership . . . .

(Rev. Proc. 84-35, quoting H.R.Rep. No. 95-1800 (Conf. Report), 2d Sess. 221 (1978), 1978-3 C.B. (Vol. 1) 521, 555.) The Senate Report pertaining to the enactment of IRC section 6698 also explained the provisions of the statute, and how the "reasonable cause" exception contained in the penalty provision should be applied. The Report states:

> The penalty will not be imposed if the partnership can show that failure to file a complete or timely return is due to reasonable cause. The committee understands that small partnerships (those with 10 or fewer partners) often do not file

[5] Although the IRS abated the 2016 penalty under Rev. Proc. 84-35, and this appeal involves TFD's 2015 year, as is explained below, we find that the basis upon which the IRS abated the penalty for 2016 also would apply to TFD's 2015 year.

DocuSign Envelope ID: 65D843C6-1B64-4806-945E-00D3A2E331A0

> partnership returns, but rather each partner files a detailed statement of his share of partnership income and deductions with his own return. *Although these partnerships may technically be required to file partnership returns, the committee believes that full reporting of the partnership income and deductions by each partner is adequate and that it is reasonable not to file a partnership return in this instance*. [Italics added.]

(Sen.Rep. No. 95-1263, 2d Sess., p. 106 (1978), 1978-3 C.B. (Vol. 1) 315, 403.) The House report contains similar language. (H.R.Rep. No. 95-1445, 2d Sess. 75 (1978), 1978-3 C.B. (Vol. 1) 181, 249; see also H.Rep. No. 95-1800, 2d Sess. p. 221 (1978).)

Rev. Proc. 81-11 effectuates this clear Congressional intent by providing, in pertinent part, as follows:

> A partnership composed of ten or fewer partners of a type that has not historically filed a partnership return . . . *will be considered to have met the reasonable cause test* and will not be subject to the penalty imposed by section 6698 of the Code for the failure to file a partnership return, provided that the partnership or any of the partners establishes, if so requested by the Service, that all partners have fully reported their shares of the income, deductions, and credits of the partnership on their timely-filed income tax returns. [Italics added.]

(*Id.* at § 3.01.) Rev Proc. 81-11 also states that:

> For purposes of section 3.01, a partnership will not be considered to be of a type that has not historically filed a partnership return unless it is a domestic partnership composed entirely of noncorporate general partners. Required to file partnership returns are partnerships with significant financial holdings, tier partnerships, and partnerships where each partner's interest in the capital and profits are not owned in the same proportion or where all items of income, deductions, and credit are not allocated in proportion to such pro rata interests.

(*Id.* at § 3.02.) Finally, section 3.04 of Rev. Proc. 81-11 states that:

> In determining whether a partner has fully reported the partner's share of the income, deductions, and credits of the partnership, . . . all the relevant facts and circumstances will be taken into account. In making this determination, the nature and materiality of any error or omission will be considered . . . . If the error or omission results in a de minimis understatement of the net amount payable with respect to any income tax, the penalty will not be asserted. However, if the error or omission results in a material understatement of the net amount payable with respect to any income tax, the partner generally will not be considered to have fully reported and the penalty will be applied.

DocuSign Envelope ID: 65D843C6-1B64-4806-945E-00D3A2E331A0

The changes made to Rev. Proc. 81-11 by Rev. Proc. 84-35 did not change the basic premise underlying Rev. Proc. 81-11. They merely "updated" its provisions to take into account the changes that were made in 1982 when consolidated partnership audit and determination procedures came into effect at the federal level as a result of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).[6] Although Rev. Proc. 81-11 was "modified and superseded" in 1984 by Rev. Proc. 84-35 in order to take into account the federal changes made by TEFRA, the basic principles of Rev. Proc. 81-11 remained in place. Smaller partnerships with 10 or fewer partners generally would come within the reasonable cause exception contained in IRC section 6698 so long as the partners duly reported their income, deductions, and credits from the partnership. However, since TEFRA contained, in newly enacted IRC section 6231(a)(1)(B), its own shorthand definition of what constitutes a small partnership for purposes of TEFRA, in Rev. Proc. 84-35 the IRS decided to use that definition in determining the type of small partnership that would qualify under the principles that were first set out in Rev. Proc. 81-11 (and reaffirmed in Rev. Proc. 84-35). Rev. Proc. 84-35 states that "domestic partnerships composed of 10 or fewer partners *and coming within the exceptions outlined in section 6231(a)(1)B) of the [IRC]* will be considered to have met the reasonable cause test and will not be subject to the penalty imposed by section 6698........" (Rev. Proc. 84-35, § 3.01 [italics added].) Because California has never conformed to the partnership consolidated audit and determination rules of TEFRA, this additional requirement is of no relevance to California taxpayers.

Unlike the situation with respect to the IRS First Time Abate program, the IRS's adoption of Rev. Procs. 81-11 and 84-35 were based on the original legislative history underlying the penalty statute. Furthermore, the IRS's interpretation of the reasonable cause provision in IRC section 6698 had been in effect for two years when the California Legislature adopted its California version of the federal penalty. "When the Legislature adopts the substance of a non-California statute, the Legislature is presumed to have acted with knowledge and in light of decisions interpreting the adopted statute." (*Hodge v. Kirkpatrick Development, Inc.* (2005) 130 Cal.App.4th 540, 555.) Therefore, "the Legislature must have intended that they

---

[6] Congress enacted TEFRA on September 3, 1982, as Pub.L. No. 97–248, 96 Stat. 324. California neither adopted nor conformed to TEFRA's consolidated partnership audit provisions.

DocuSign Envelope ID: 65D843C6-1B64-4806-945E-00D3A2E331A0

should have the same meaning, force and effect . . . . " (*Id.* at p. 556; see also *Kahn v. Kahn* (1977) 68 Cal.App.3d 372, 384.)

We asked FTB to submit additional briefing on the applicability of the federal rulings in this area (particularly Rev. Proc. 84-35 and IRS Chief Counsel Memorandum No. 201733013) to the issues in this appeal. In its response, FTB claimed that those rulings were irrelevant because they only applied to "small partnerships" as defined by IRC section 6231(a)(1)(B). FTB contends that "California law does not conform to the definition of a 'small partnership' under IRC section 6231, subdivision (a)(1)(B), and the applicable federal tax law filing requirements," therefore Rev. Proc. 84-35 and the other IRS rulings in this area "do[] not apply to this appeal." FTB asserts that, unlike federal law, "California makes no distinction between partnerships and 'small partnerships' and requires all partnerships [to] file a partnership return."

FTB's argument is erroneous and misses the point. The small partnership exception contained in IRC section 6231 does not abrogate the requirement that all partnerships, including small partnerships, must file a federal partnership return. The legal requirement in federal law that partnerships file partnership (information) returns is contained in IRC section 6031(a). It requires that *all* partnerships, as defined in IRC section 761(a), file federal partnership returns.[7] California also requires that *all* partnerships file partnership returns. (R&TC, § 18633.) Furthermore, California conforms to the definition of "partnership" contained in IRC section 761(a). (See R&TC, § 17851.)

The "small partnership" exception contained in IRC section 6231 meant that small partnerships (as defined therein) were not automatically subject to the TEFRA consolidated partnership audit provisions. After the enactment of TEFRA, the federal definition of "small partnerships" also was used by Rev. Proc. 84-35 to update the small partnership exception to the IRC section 6698 penalty that already was in existence in federal law (and which had been the basis for Rev. Proc. 81-11). In effect, it became a shorthand reference for the types of

[7] The definition of "partnership" contained in IRC section 761(a), which is applicable for purposes of the federal partnership filing requirement contained in IRC section 6031(a), provides as follows:

> For purposes of this subtitle, the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate. . . .

IRC section 761(a) is contained in subchapter K of chapter 1 of subtitle A of the IRC. IRC section 761(a)'s definition of "partnership" (together with most of subchapter K) applies for California tax purposes, including the partnership return filing requirement of R&TC section 18633. (See R&TC, § 17851.)

DocuSign Envelope ID: 65D843C6-1B64-4806-945E-00D3A2E331A0

partnerships that the IRS viewed Congress as having in mind when it indicated that "smaller partnerships" of 10 or fewer partners should be excepted from the penalty provisions of IRC section 6698. Although FTB correctly notes that California never conformed to TEFRA, that is of no import. The IRS's use of TEFRA's small partnership definition to replace the pre-TEFRA definition of smaller partnerships that qualify for the reasonable cause penalty exception (as set forth in Rev. Proc. 81-11) does not mean that the pre-TEFRA exception that was in effect at the time that California adopted its version of the federal per partner late-filing penalty ceased to have any applicability. We find that the IRS's interpretation of the penalty provision's "reasonable cause" exception (as set forth in Rev. Procs. 81-11 and 84-35) was a reasonable one in light of the clear legislative history underlying that interpretation. There is nothing in the legislative history underlying the predecessor to R&TC section 19172 indicating that the Legislature—or FTB—disagreed with that interpretation at the time the Legislature enacted California's version of the partnership late-filing penalty.[8]

Finally, we note that the IRS only abated the penalty for the 2016 year under Rev. Proc. 84-35, not the penalty for the 2015 year. It appears to us that both years would have been subject to penalty abatement under the principles set forth in Rev. Proc. 84-35 (and its predecessor Rev. Rul. 81-11), but that since the IRS already had abated the 2015 penalty under its First Time Abate program, there was no need for the IRS to also rule on the applicability of Rev. Proc. 84-35. Furthermore, when we asked FTB to provide additional briefing to us regarding the applicability of Rev. Proc. 84-35 to this matter, it raised no contention that TFD failed to qualify under its terms as a factual matter. It only argued that, as a legal matter, the principles set forth in Rev. Proc. 84-35 were inapplicable for California tax purposes.[9] We reject this argument.

---

[8] We note that in 1988 FTB issued Notice 88-692 (1988 WL 188431), which acknowledges that Rev. Proc. 81-11 is applicable for California tax purposes, but concludes that Rev. Proc. 84-35 is not. It is unclear to us whether FTB still considers this notice valid, inasmuch as it is not available on FTB's public website, <www.ftb.ca.gov>. If it is still valid, however, it provides further support for our holding.

[9] Although Ms. Beshears admits that she did not claim the small loss generated by TFD, this is not the sort of reporting inconsistency that disqualifies TFD from the protections of Rev. Proc. 84-35. The revenue procedure envisions that an inconsistency in reporting would have to generate more than a *de minimis* understatement for it to become inapplicable. (See Rev. Proc. 84-35, § 3.04.)

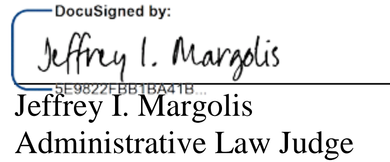
DocuSign Envelope ID: 65D843C6-1B64-4806-945E-00D3A2E331A0

## HOLDING

TFD is not liable for the per partner late-filing penalty imposed by FTB.

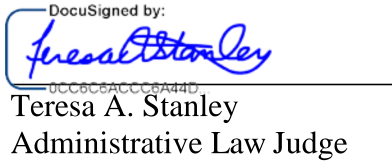
## DISPOSITION

FTB's action denying TFD's claim for refund is reversed.

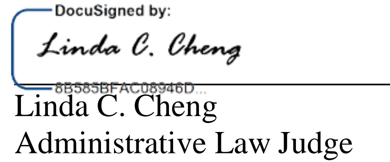


Jeffrey I. Margolis
Administrative Law Judge

We concur:



Teresa A. Stanley
Administrative Law Judge



Linda C. Cheng
Administrative Law Judge