

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:) OTA Case No. 18042837
PEHONG CHEN AND)
ADELE CHI)
_____)

OPINION

Representing the Parties:

For Appellants: Robert W. Wood, Attorney

For Respondent: Nathan H. Hall, Tax Counsel III

For Office of Tax Appeals: Andrew Jacobson, Tax Counsel III

J. LAMBERT, Administrative Law Judge: Pursuant to Revenue and Taxation Code (RT&C) section 19045, Pehong Chen and Adele Chi (appellants) appeal actions by respondent Franchise Tax Board (FTB) proposing to assess additional tax of \$44,514, plus interest, for the 2011 tax year, and additional tax of \$75,713, plus interest, for the 2012 tax year.

Appellants have waived their right to an oral hearing; therefore, the matter is being decided based on the written record.

ISSUE

Whether appellants have demonstrated error in FTB’s proposed assessments.

FACTUAL FINDINGS

1. From 2000 through 2004, appellants, acting through the Chen Family Trust (Trust), purchased 157 shares of stock of Kiwi II Ventura Serviços De Consultorlo S.A. (Kiwi) for a total of \$3,198,862.
2. Kiwi, a venture capital initiative based in Portugal,¹ was established in 2000 and was scheduled to exist for a 10-year period.

¹ Kiwi, a Portuguese “sociedade anonima,” is taxed as a C corporation for federal income tax purposes. (Treas. Reg. § 301.7701-2(b)(8)(i).)

3. According to Annual Information Statements issued by Kiwi to the Trust, Kiwi made total payments to appellants of \$637,389, as follows: (1) 2007: \$230,882; (2) 2009: \$203,309; (3) 2010: \$122,338; and (4) 2011: \$80,860.² The statements indicate that Kiwi had no current or accumulated earnings and profits for the 2011 tax year.
4. Appellants timely filed a joint 2007 California resident income tax return that did not report any dividend income on the distributions from the Kiwi stock. On December 30, 2008, appellants filed an amended 2007 return, which also reported no dividend income from Kiwi. On September 14, 2011, appellants filed a second amended 2007 return, which, again, did not show any dividend income from Kiwi. The second amended return stated that any income or loss from Kiwi was recognized under the mark-to-market (MTM) election for federal tax purposes, and since Kiwi was a passive foreign investment company (PFIC), any income and loss generated by Kiwi was not subject to California tax.³ FTB accepted appellants' 2007 second amended return as filed.
5. Appellants filed a joint 2009 California resident income tax return, which reported a long-term capital gain of \$221,531 from a distribution with respect to the Kiwi stock. However, appellants filed a 2009 amended tax return, which removed the capital gain. The return stated that any income or loss from Kiwi was recognized under the MTM election for federal tax purposes, and since Kiwi was a PFIC, any income or loss generated by Kiwi was not subject to California tax. FTB accepted appellants' 2009 amended return as filed.
6. Appellants timely filed a joint 2010 California resident income tax return that did not report any dividend income on the distributions of \$122,338 from the Kiwi stock.
7. Kiwi closed its business operations in 2011 and its liquidation was complete on December 29, 2011. Appellants timely filed a joint 2011 California resident income tax return that did not report any dividend income on the distributions of \$80,860 from the Kiwi stock. On the return, appellants reported a sale of 157 shares of Kiwi stock with a cost basis of \$3,198,862 and a loss in the same amount, due to the closing of Kiwi's business operations. On February 15, 2013, appellants filed an amended 2011 return, which did not make any adjustment with respect to the Kiwi stock. Appellants claimed

² Kiwi closed business operations in 2011.

³ California does not conform to the federal PFIC rules. (R&TC, § 24995.)

\$3,000 of the capital losses in 2011, resulting in a capital loss carryover to their 2012 taxable year in the amount of \$569,267.⁴

8. FTB audited appellants' 2011 return and determined that the distributions in 2007, 2009, 2010, and 2011 were non-dividend distributions that reduced their stock basis. Accordingly, FTB reduced the stock basis of \$3,198,862 by the total reported distributions of \$637,389, which reduced the reported loss of \$3,198,862 by that amount. On March 31, 2017, FTB issued Notices of Proposed Assessment (NPAs) for 2011 and 2012. The 2011 NPA disallowed appellants' claimed capital loss of \$3,000 and increased their capital gain by \$553,426, increasing their taxable income in the aggregate by \$556,426.⁵ The NPA proposed to assess additional tax of \$44,514, plus interest.
9. The 2012 NPA disallowed a capital loss carryover of \$569,267, increasing appellants' taxable income by the same amount. The NPA proposed to assess additional tax of \$75,713, plus interest.
10. Appellants protested the NPAs. On January 12, 2018, FTB issued Notices of Action for 2011 and 2012, which affirmed its NPAs for both years. This timely appeal followed.

DISCUSSION

FTB's determination is presumed correct, and a taxpayer has the burden of proving error. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Myers* (2001-SBE-001) 2001 WL 37126924.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Magidow* (82-SBE-274) 1982 WL 11930.) In the absence of credible, competent, and relevant evidence showing that FTB's determination is incorrect, it must be upheld. (*Appeal of Seltzer* (80-SBE-154) 1980 WL 5068.)

Internal Revenue Code (IRC) section 1001 provides that the gain on the sale of property shall be the excess of the amount realized over the adjusted basis of the property.⁶ IRC section 1011 provides that the adjusted basis for determining the gain from the sale of property

⁴ Appellants also reported capital gains and losses on their return unrelated to Kiwi, which resulted in a net capital loss carryover of -\$569,267.

⁵ The discrepancy between the contested adjustment of \$637,389 and the NPA amount of \$556,426 is a result of another adjustment determined during audit, which was not contested by appellants, along with the netting of appellants' capital gains and losses.

⁶ California conforms to IRC sections 1001 and 1011 through 1016 at

shall be the property's initial basis (determined under IRC section 1012 or other applicable statutes in that subchapter) adjusted as provided for in IRC section 1016. IRC section 1012 provides that the basis of property generally shall be the cost of such property.

IRC section 316, incorporated by R&TC section 17321, provides that a dividend means any distribution of property made by a corporation to its shareholders out of its earnings and profits accumulated after February 28, 1913, or out of its earnings and profits of the taxable year. IRC section 301(c)(1) states that the portion of the distribution which is a dividend shall be included in gross income. Dividends will be considered to have been paid in the following order: (1) from the earnings and profits of the taxable year; (2) from the earnings and profits accumulated since February 28, 1913; and (3) from sources other than earnings and profits only after the earnings and profits have been distributed. (IRC, § 316(a) [flush language]; Treas. Reg. § 1.316-2(a).)

If the earnings and profits of the taxable year (computed as of the close of the year without diminution by reason of any distributions made during the year and without regard to the amount of earnings and profits at the time of the distribution) are sufficient in amount to cover all the distributions made during that year, then each distribution is a taxable dividend. (Treas. Reg. § 1.316-2(b).) In general, a distribution of property made by a corporation to a shareholder with respect to its stock that is not a dividend shall be applied against and reduce the adjusted basis of the stock. (IRC, § 301(c)(2).) The portion of a distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property. (IRC, § 301(c)(3).)

Appellants received distributions of \$230,882 for 2007, \$203,309 for 2009, \$122,338 for 2010, and \$80,860 for 2011, totaling \$637,389. Contrary to what was reported to FTB on their tax returns (both original and amended), appellants now argue that the distributions were dividends that did not reduce their stock basis in Kiwi. On the other hand, FTB argues that appellants are barred by the duty of consistency and, as a result, the distributions must be treated as originally reported -- as non-dividend distributions that reduced their stock basis.

The duty of consistency, like the doctrine of judicial estoppel, “precludes a party from gaining an advantage by taking one position, and then seeking a second advantage by taking an incompatible position.” (*Estate of Ashman v. Commissioner* (9th Cir. 2000) 231 F.3d 541, 543 (*Ashman*), quoting *Rissetto v. Plumbers & Steamfitters Local 343* (9th Cir. 1996) 94 F.3d 597,

600.) The duty of consistency requires a showing of three elements: (1) a representation or report by the taxpayer; (2) on which FTB has relied; and (3) an attempt by the taxpayer after the statute of limitations has run to change the previous representation or to recharacterize the situation in such a way as to harm FTB. (*Ashman, supra*, 231 F.3d at p. 546, quoting *Herrington v. Commissioner* (5th Cir. 1988) 854 F.2d 755, 758.)

Here, in our view, on their original and amended tax returns for the 2007 through 2010 tax years, appellants essentially represented that the distributions were non-dividend distributions because they did not pay tax on them. Appellants now attempt to recharacterize the distributions as taxable dividends after the statute of limitations has run to assess them additional taxes. R&TC section 19057(a) generally provides that FTB shall mail a notice of a proposed deficiency assessment to the taxpayer within four years after the return was filed. Therefore, the statute of limitations has long expired for the 2007, 2009, and 2010 tax years and FTB cannot propose an assessment of additional taxes on the alleged dividend income.

Appellants argue that the reporting of a distribution as a dividend does not change its underlying nature, citing *Halpern v. Commissioner*, T.C. Memo. 1982-31 (*Halpern*). However, *Halpern* does not apply to this appeal, as we are not addressing whether the amounts were dividends or non-dividend distributions, but rather whether appellants must continue to treat the amounts as non-taxable distributions under the duty of consistency. Appellants also argue that the duty of consistency only applies to issues of fact, not law, citing *UNUM Corp. v. United States* (D.Me. 1995) 886 F.Supp. 150 (*UNUM*). In *UNUM*, the Internal Revenue Service (IRS) was aware of the facts at all times, as it conducted an in-depth audit within the limitations period. In the present appeal, appellants represented that the amounts were non-taxable distributions and FTB did not conduct an audit of the 2007, 2009, and 2010 tax years. Furthermore, the court in *UNUM* found that the IRS was not injured by the taxpayer's recharacterization because the taxation was passed to another party. This is not the case in the present appeal because, if appellants were not bound by the duty of consistency, the alleged dividends would escape taxation without reducing the basis of the Kiwi stock. Therefore, appellants are barred by the duty of consistency from recharacterizing the payments received in 2007, 2009, and 2010 as dividends.

Unlike the 2007, 2009, and 2010 tax years, appellants' 2011 tax year is still subject to adjustment because it is not barred by the statute of limitations. However, appellants concede

that, for the 2011 tax year, Kiwi had no current or accumulated earnings and profits from which to pay a dividend, which is corroborated by Kiwi’s 2011 Annual Information Statement. Therefore, we conclude the 2011 payment of \$80,860 must be treated as a non-dividend distribution that reduces appellants’ stock basis in Kiwi. As such, the payments at issue totaling \$637,389 were properly treated as a return of capital that lowered appellants’ basis in their Kiwi stock.

HOLDING

Appellants have failed to demonstrate error in FTB’s proposed assessments.

DISPOSITION

FTB’s action is sustained.

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Josh Lambert
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Josh Lambert
Administrative Law Judge

We concur:

DocuSigned by:
Richard I. Tay
F8E81582726E448...
Richard I. Tay
Administrative Law Judge

DocuSigned by:
Patrick J. Kusiak
8E20779E0CD743E...
Patrick J. Kusiak
Administrative Law Judge

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