OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18011019
MARTIN M. DEASY	)
	) Date Issued: March 27, 2019
	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Martin M. Deasy, M.D.
For Respondent:	Greg W. Heninger, Program Specialist II
For Office of Tax Appeals:	Tom Hudson, Tax Counsel III

T. STANLEY, Administrative Law Judge: Pursuant to California Revenue and Taxation Code (R&TC) section 19045, appellant, Martin M. Deasy, appeals from the action of respondent Franchise Tax Board (FTB) affirming its proposed assessment of $16,850 in additional tax, a late-filing penalty of $4,212.50, a demand penalty of $4,212.50, and a filing enforcement cost recovery fee (filing enforcement fee) of $79, plus applicable interest, all for 2014.

Appellant waived his right to an oral hearing; therefore, we decide the matter based on the written record.

ISSUES

1. Has appellant established that he is entitled to a reduction in the proposed assessment of additional tax?
2. Has appellant shown that his late filing was due to reasonable cause?
3. Is appellant liable for the demand penalty?
4. Is appellant liable for the filing enforcement fee?

FACTUAL FINDINGS

1. On April 16, 2015, FTB received a tax payment of $1,974 from appellant for his 2014 tax. Appellant made two additional payments of $39.51, each on August 1, 2015 and on August 15, 2015.
2. FTB received information from the California Board of Medical Quality Assurance that appellant was a licensed psychiatrist during 2014. FTB had not received a California income tax return filed by appellant for that year.
3. FTB issued a Demand for Tax Return (Demand) to appellant on December 16, 2015. The Demand required that appellant file a 2014 California income tax return, send a copy of the return if he had already filed it, or explain why he was not required to file a return. Appellant did not respond by the January 20, 2016 deadline.
4. FTB issued a Notice of Proposed Assessment (NPA) to appellant on February 16, 2016. The NPA indicates that FTB estimated appellant's income to be $212,153, which is based on the average income reported by individuals licensed by the Board of Medical Quality Assurance. After allowing a standard deduction of $3,992, the NPA proposed additional tax of $16,850, a late-filing penalty of $4,212.50, a demand penalty of $4,212.50, a filing enforcement fee of $79, plus applicable interest. The NPA did not acknowledge or otherwise reference appellant's tax payment of $1,974 on April 16, 2015.
5. Appellant protested the NPA by a letter dated April 18, 2016, claiming that he was employed on a temporary basis for fourteen weeks and three days in 2014. Appellant submitted Form 1099-MISC from Psychiatrists Only, LLC, showing non-employee compensation of $70,679.76, and Form 1099-INT from New York University Hospital Center, showing interest income of $360.63. Appellant indicated that he would complete his return soon.
6. When appellant did not file his tax return, FTB issued a Notice of Action, dated September 2, 2016, which affirmed the NPA. This timely appeal followed.
7. Appellant failed to file a prior year's (2013) tax return. As a result, FTB issued a Request for Tax Return (Request) on April 22, 2015. Appellant's response was due by May 27, 2015. Thereafter, appellant's time to respond was extended by FTB, to June 26, 2015. FTB issued an NPA for 2013 on July 20, 2015, after appellant failed to file his 2013 tax return by the extended due date.

8. On July 11, 2018, the Office of Tax Appeals (OTA) conducted a telephone conference during which Appellant agreed to file his 2014 tax return no later than July 17, 2018, which he did.
9. FTB thereafter issued a Notice of Tax Return Change – No Balance (Notice of Tax Return Change) for 2014, showing a tax of $1,598 and a late-filing penalty of $399.50. After deducting payments totaling $2,092.94, the Notice showed a revised balance of $0.

DISCUSSION

Issue 1 – Has appellant established that he is entitled to a reduction in the proposed assessment of additional tax?

Initially, appellant appealed the proposed assessment of tax for 2014, which was based on an estimate of his income by FTB. Appellant has now filed his tax return, and FTB accepted that return. Therefore, appellant established that he is entitled to a reduction of his tax liability from $16,850 to $1,598.

Issue 2 – Has appellant shown that his late filing was due to reasonable cause?

R&TC section 19131 provides that FTB shall impose a late-filing penalty when a taxpayer fails to file a tax return on or before its due date unless the taxpayer establishes that the late filing was due to reasonable cause and was not due to willful neglect. The penalty is computed at 5 percent of the tax due, after allowing for timely payments, for every month that the return is late, up to a maximum penalty of 25 percent. The burden is on the taxpayer to establish reasonable cause for untimely filing. (*Appeal of Scott*, 82-SBE-249, Oct. 14, 1982.)[1] Reasonable cause exists if it can be shown that the taxpayer acted as an ordinarily intelligent and prudent businessperson would have acted under similar circumstances. (*Appeal of Bieneman*, 82-SBE-148, July 26, 1982; *Appeal of Tons*, 79-SBE-027, Jan. 9, 1979.)

Here, appellant explained in an Attachment to Quick Resolution Worksheet, dated April 18, 2016, that he was missing some documents he needed in order to file his 2014 tax return. He concluded that he expected "to find or replace those documents" soon. There was no further explanation for his continued failure to file a tax return for 2014. In a letter dated September 14,

[1] Precedential opinions of the State Board of Equalization (BOE) are available for viewing on the BOE's website: <http://www.boe.ca.gov/legal/legalopcont.htm>.

2017, BOE[2] sent appellant a request for additional briefing. In that letter, appellant was specifically asked if he was prevented from filing a timely tax return by a reasonable cause. Appellant did not respond to that letter. Therefore, we find that appellant has not established reasonable cause to abate the late-filing penalty, and that the reduced penalty amount set forth in the Notice of Tax Return Change ($399.50) is correct.

Issue 3 – Is appellant liable for the demand penalty?

California imposes a penalty for the failure to file a return or to provide information upon FTB's demand to do so, unless reasonable cause prevented the taxpayer from responding to the demand. (R&TC, § 19133.) For individual taxpayers, FTB may only impose a demand penalty if a taxpayer fails to respond to a current Demand, and FTB issues an NPA under the authority of R&TC section 19087(a), after the taxpayer failed to timely respond to a Request or Demand at any time during the four taxable years preceding the year for which the current Demand is being issued. (Cal. Code Regs., tit. 18 (Regulation), § 19133(b).) The demand penalty is designed to penalize the failure of a taxpayer to respond to a notice and demand, and not a taxpayer's failure to pay the proper tax. (*Appeal of Bryant*, 83-SBE-180, Aug. 17, 1983; *Appeal of Hublou*, 77- SBE-102, July 26, 1977.)

Pursuant to R&TC section 19503, FTB has the authority to prescribe rules and regulations necessary to enforce the Personal Income Tax Law. FTB exercised that authority in promulgating Regulation section 19133, which states how FTB will exercise the discretion granted in the demand penalty statute. (See R&TC, § 19133 [FTB "may" add a penalty].) That regulation provides that for individuals, the demand penalty will only be imposed if the following two conditions are satisfied:

1. the taxpayer fails to timely respond to a current Demand for Tax Return in the manner prescribed, and
2. the FTB has proposed an assessment of tax under the authority of Revenue and Taxation Code section 19087, subdivision (a), after the taxpayer failed to timely respond to a Request for Tax Return or a Demand for Tax Return in the manner prescribed, at any time *during the four-taxable-year period preceding the taxable year for which the current Demand for Tax Return is issued*.

(Regulation § 19133(b)(1)-(2), emphasis added.)

[2] Appellant filed this appeal with the BOE, which is the OTA's predecessor with respect to most types of tax appeals.

The rules of statutory construction apply when interpreting regulations promulgated by administrative agencies. (*Butts v. Board of Trustees of California State University* (2014) 225 Cal.App.4th 825, 835 (*Butts*).) A regulation, and each word and phrase in a regulation, must be given its plain, common sense meaning. (*Ibid.*) Only if the meaning cannot be determined from the plain language of the regulation, do we look to extrinsic aids to ascertain its intent. (*Id*., at p. 836.) Moreover, when the plain language of a regulation is unambiguous, we need not inquire into FTB's interpretation of it. (See *Barnhart v. Sigmon Coal Co.* (2002) 534 U.S. 438, 450 [The inquiry ceases "if the statutory language is unambiguous and 'the statutory scheme is coherent and consistent.'"]; *Desert Palace, Inc. v. Costa* (2003) 539 U.S. 90 ["Where, as here, the words of the statute are unambiguous, the judicial inquiry is complete."].)

FTB appears to apply the regulation in a manner that would substitute the word "for" in place of "during." Based upon the plain meaning of the regulation above, we find, contrary to FTB's assertion in this case, that subsection (b)(2) of the regulation requires that a Request or Demand for a prior year's return must have been issued at any time "*during* the four-taxable-year period preceding" the current tax year for which FTB seeks to impose the demand penalty. However, the regulation may not be rewritten "to make it conform to a presumed intention which is not expressed." (*Seaboard Acceptance Corp. v. Shay* (1931) 214 Cal. 361 365.) The plain meaning of the word "during" in the regulation must be interpreted to mean that a taxpayer's failure to respond to a Request or Demand must have occurred at any time during the four-taxable-year period preceding the taxable year for which the demand penalty is at issue. Moreover, giving each phrase its plain, common meaning, as required by *Butts*, the usage of "at any time," followed by the word "during" does not lend itself to an alternate meaning. (See R&TC, § 19133(b)(2).) If "during" is interpreted as "for," the words "at any time" become meaningless surplus words. FTB's proposed application of the regulation would ignore that phrase, while we must give significance to every word, phrase, and sentence. (*Curle v. Superior Court* (2001) 24 Cal.4th 1057, 1063.)

The taxable year for which FTB desires to impose the demand penalty is 2014. In order to apply the demand penalty consistent with the regulation, appellant must have failed to respond to a prior Request or Demand in either 2010, 2011, 2012, or 2013 (the four tax-year period

preceding 2014), and, as a result, an NPA must have been issued.[3] However, appellant's failure to respond to FTB's prior Request occurred in 2015. Thus, FTB cannot apply the penalty in this appeal consistent with its own regulation.[4]

Although the plain meaning of the regulation is clear, an ambiguity exists between the regulation and its Example 2. To the extent that Example 2 of Regulation § 19133 is inconsistent with the result herein, we decline to defer to Example 2's illustration of the regulation. (See Regulation § 19133(d).) In that example, an NPA was issued in 2001 after the taxpayer failed to respond to a Request for 1999. (*Ibid.*) Subsequently a Demand and NPA were issued for 2001, and the example states that the demand penalty would apply. (*Ibid.*) The application in the illustrative example conflicts with the plain language of the regulation.

As stated in section 19133(d), the examples are only "intended to illustrate the provisions of this regulation." The examples at issue here constitute FTB's interpretation of its regulation. FTB, in promulgating the regulation, exercised its discretion and determined under what circumstances the statutory penalty would apply. When assessing the validity of an interpretation, such as in Example 2 of the regulation, the scope of review does not require the same level of deference as would a quasi-legislative rule. (*Yamaha Corp. of America v. State Board of Equalization* (1988) 19 Cal.4th 1, 11 (*Yamaha*).) While courts have held that an agency's interpretation of its own regulation is entitled to deference, that deference is not unlimited. (See *Auer v. Robbins* (1997) 519 U.S. 452; *Stinson v. United States* (1993) 508 U.S. 36.) If the agency's interpretation is plainly erroneous or inconsistent with a regulation that is unambiguous, it is not entitled to deference. (*Stinson v. United States, supra,* at p. 45; *Bowles v. Seminole Rock & Sand Co.* (1945) 325 U.S. 410, 414.) The agency's interpretation becomes only one of several tools to interpret the regulation, but independent review is required. (*Yamaha, supra,* at pp. 7-8; *Agnew v. State Board of Equalization* (1999) 21 Cal.4th 310, 322.)

[3] We do not address whether the prior year's Request/Demand or the NPA must have been issued during the four years preceding the current tax year since in this appeal neither occurred.

[4] We note that, as applied to appellant, FTB's interpretation of Regulation 19133 operates in a way that was expressly rejected by FTB's three-member board. Here, the first NPA issued (on July 20, 2015), after appellant failed to file his 2014 tax return. Thus, the notice to the taxpayer of the need to comply with the filing requirement (i.e., the NPA for the prior year) was received *after* the taxpayer already had failed to comply with the filing requirement for the current year. The application of the regulation in this manner does not provide the notice to taxpayers intended by the regulation, nor does it effectively "target[] only repeat nonfilers." Thus, FTB's application would penalize appellant in a way that FTB expressly rejected when adopting the regulation. (Cal. Reg. Notice Register 2004, No. 17-Z, p. 504; https://www.ftb.ca.gov/law/regs/19133_isr.pdf.)

Regulation § 19133 is unambiguous – its plain language says what it means. Deferring to the agency's interpretation here would permit FTB to "create *de facto* a new regulation." (See *Christensen v. Harris County* (2000) 529 U.S. 576, 588 [rejecting deference to an agency letter that was intended to interpret the agency's regulation].) As discussed above, the plain language of Regulation 19133(b) states that a taxpayer's failure to respond to a Request or Demand must have occurred during one of the four taxable years preceding the taxable year for which the second Demand and NPA were issued. To the extent that Example 2 of Regulation 19133, which is simply an interpretation of the rule, suggests that the first failure must have occurred *for* one of the four preceding taxable years, we hold that it is inconsistent with the unambiguous language of the regulation and is incorrect.[5]

Because appellant's failure to respond to the demand for a 2013 return did not occur during any of the four taxable years prior to 2014, the demand penalty may not be imposed for 2014.

Issue 4 – Is appellant liable for the filing enforcement fee?

Section 19254(a)(2) authorizes the imposition of a filing enforcement fee when FTB mails a notice to a taxpayer that the continued failure to file a return may result in the imposition of the fee. The amount is determined annually to reflect actual costs as reflected in the annual Budget Act. (R&TC, § 19254(b).) Once the fee is properly imposed, there is no language in the statute that would excuse the fee for reasonable cause. (*Appeal of Myers*, 2001-SBE-0001, May 31, 2001.) Appellant has not disputed the amount of the fee, which is set by statute. Accordingly, we have no basis upon which to overturn FTB's imposition of the filing enforcement fee.

HOLDINGS

1. Appellant established that he is entitled to a reduction from his proposed tax liability for 2014, from $16,850 to $1,598.
2. Appellant has not established reasonable cause to abate the late-filing penalty in the reduced amount of $399.50 reflected in the Notice of Tax Return Change.

[5] We note that the concerns of the dissent would be best addressed by the well-vetted regulatory process of proposing or amending regulations (which typically includes opportunity for public input and review by the Office of Administrative Law).

3. The demand penalty was incorrectly applied.

4. Appellant has not established that the filing enforcement cost recovery fee was incorrect or was improperly imposed.

DISPOSITION

Appellant's tax liability is reduced, as conceded by FTB. FTB's action in assessing the late-filing penalty, in the reduced amount of $399.50, is sustained. The demand penalty is reversed. The filing enforcement cost recovery fee is sustained.

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Teresa A. Stanley
Administrative Law Judge

I concur:

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Sara A. Hosey
Administrative Law Judge

DISSENT

N. DANG, Administrative Law Judge: I concur with the majority's holding regarding Issues 1, 2, and 4, above. I dissent, however, from the majority's holding in Issue 3, regarding the application of the demand penalty. The proper interpretation of California Code of Regulations, title 18, section (Regulation) 19133, requires that the regulatory language be examined in its entirety to ascertain and effectuate the true purpose of the regulation. Relying solely upon the ordinary meaning of "during," without due consideration for the entirety of the regulatory language, leads to a demonstrably "absurd result" which is directly contrary to FTB's expressly stated purpose for promulgating this regulation.

It is well established that the rules of statutory construction apply equally to the interpretation of administrative regulations. (*Hoitt v. Department of Rehabilitation* (2012) 207 Cal.App.4th 513, 523.) In construing a regulation, the primary purpose is to "ascertain the intent of the administrative agency that issued the regulation." (*Ibid.*) The most reliable indicator of that intent, is the words of the regulation themselves, given their usual and ordinary meaning. (*People v. Lawrence* (2000) 24 Cal.4th 219, 230.) Every word, phrase, sentence, and part of a regulation should be given significant consideration in discerning its purpose. (*Curle v. Superior Court* (2001) 24 Cal.4th 1057, 1063.) However, that language is not examined in isolation, but in the context of the regulatory framework as a whole to determine the scope and purpose of the regulation and to harmonize its various parts. (*Sierra Club v. Superior Court* (2013) 57 Cal.4th 157, 165.) "If the language is clear, courts must generally follow its plain meaning unless a literal interpretation would result in absurd consequences the [administrative agency] did not intend." (*Id*. at pp. 164—165.)

When considered in its entirety, the language of Regulation 19133 is unclear as to the proper application of the demand penalty. As stated in the majority opinion, the plain language of subdivision (b)(2) provides that FTB will impose the demand penalty only where the requisite NPA was issued *during* one of the prior four taxable years. However, Example 2 of the regulation, as provided in subdivision (d), indicates that FTB will impose the demand penalty where the requisite NPA was issued *for* one of the prior four taxable years. That example is not a post-enactment interpretation taken by FTB, but part of the text of the enacted regulation itself, and, along with subdivision (b)(2), should be given significant consideration in determining the intent of the drafter. The plain meaning of these two subdivisions of Regulation 19133 are in

direct conflict, and call for substantially differing applications of the demand penalty. And where, as here, the application of a regulation is unclear, courts may look to extrinsic sources for guidance. (*Sierra Club v. Superior Court, supra*, 57 Cal.4th at p. 166.)

FTB's rulemaking file for Regulation 19133 contains FTB's Initial Statement of Reasons, which explains the purpose for why this regulation was promulgated.[1] The Initial Statement of Reasons states that:

> It has been the practice of the Franchise Tax Board to assess the notice and demand penalty against all taxpayers who fail to respond to the notice and demand letter, without consideration of their past filing history. Many of these nonfilers are first-time nonfilers . . . . Their failure to file their tax return was an isolated incident.
>
> Because of the manner in which the penalty is calculated..... and because of its application to all nonfilers (irrespective of prior filing history), some have viewed the Franchise Tax Board's policy of assessing a notice and demand penalty as unduly harsh . . . .
>
> Under this proposed regulation, the Franchise Tax Board defines a repeat nonfiler as an individual who has received a proposed assessment of tax after receiving and failing to respond to either a request for tax return or a demand for tax return within the previous four years. The Franchise Tax Board has also determined that four years is a reasonable period of time to look back in making a determination as to whether a taxpayer is a repeat nonfiler.
>
> Therefore, the Franchise Tax Board will issue a demand for tax return to those taxpayers who are repeat nonfilers. The failure by the repeat nonfiler to respond to a demand for tax return in the manner and within the time period specified in the demand for tax return will trigger the assessment of the notice and demand penalty on a proposed assessment of tax. On the other hand, the Franchise Tax Board will not assess the notice and demand penalty against those individual taxpayers who are not identified as repeat nonfilers.

(Cal. Reg. Notice Register 2004, No. 17-Z, p. 504.)

It is clear from the above language that the purpose of Regulation 19133 is to mitigate the perceived "harshness" of the demand penalty by imposing it only upon repeat nonfilers. However, this purpose is frustrated by applying a literal reading of subdivision (b)(2) to the facts of the instant appeal; that is, it would prevent FTB from imposing the demand penalty upon a repeat nonfiler where the failure to file occurs in two consecutive years.

[1] As of February 26, 2019, the rulemaking file is currently available at FTB's website at: <www.ftb.ca.gov/Law/Final_Regulations.shtml>

Here, appellant failed to file returns for the 2013 and 2014 taxable years. Appellant's return for the 2013 tax year was due in 2014, making it impossible for FTB to issue the requisite NPA for the 2013 tax year any earlier than 2014. However, a literal application of subdivision (b)(2), would require FTB to do the impossible by issuing the NPA for the 2013 tax year *during* one of the four taxable years prior to 2014 (e.g., 2013, 2012, 2011, or 2010). This would prevent FTB from imposing the demand penalty upon appellant, even though he was a repeat nonfiler. This is an absurd result which is not in keeping with the purpose of Regulation 19133.

A literal application of subdivision (b)(2) also fails to properly account for the taxpayer's prior four-year filing history. By requiring only that FTB issue the requisite NPA *during* the prior four years, that NPA could conceivably be issued *for* any tax year open to assessment. The absurdity of this interpretation is best demonstrated where no return is filed. In this situation, there would be no time limit for FTB to issue the requisite NPA. (R&TC, § 19057.) Thus, where the taxpayer fails to file a return, FTB could have issued the requisite NPA for a tax year decades past, so long as it was issued *during* one of the four prior taxable years. This would in effect, eliminate the originally contemplated four-year lookback period for evaluating whether a taxpayer was a repeat non-filer for purposes of imposing the demand penalty. Thus, contrary to the stated purpose of Regulation 19133, taxpayers who previously made timely returns for the prior four years would be subject to the demand penalty.

While the majority is correct that, as a general principle, courts should not seek to rewrite the plain and unambiguous language of a statute, "[t]hat rule is not applied, however, when it appears clear that a word has been erroneously used, and a judicial correction will best carry out the intent of the adopting body." (*People v. Skinner* (1985) 39 Cal.3d 765, 775.) For example, the inadvertent use of "and" where the clear intent or purpose of a statute requires "or," is one such situation "which may properly be rectified by judicial construction." (*Ibid.*) The determination of whether a word was used erroneously, is accomplished by referring to the purpose of the statute and the intent of the adopting body. (*Id.* at p. 776.) Based on the above language from FTB's Initial Statement of Reasons, Example 2 of the regulation, and the demonstrably absurd results which follow a literal interpretation of subdivision (b)(2), it is apparent that the use of the word "during" was the result of a drafter's error. Under these circumstances, substituting the intended "for" in place of "during" in subdivision (b)(2) is

necessary to properly effectuate the stated purpose of the regulation. Therefore, I would sustain FTB's imposition of the demand penalty.

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Nguyen Dang
Administrative Law Judge