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2020 – OTA – 075
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18011377
PAUL B. THOMPSON; AND KATHLEEN D. THOMPSON	) Date Issued: December 4, 2019

OPINION

Representing the Parties:

For Appellants: Betty J. Williams, Attorney
Michael W. Pearson, Attorney
Cary Gaidano, CPA

For Respondent: Chris Casselman, Tax Counsel IV
Roman D. Johnston, Asst. Chief Counsel
Michael Cornez, Tax Counsel V

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

T. LEUNG, Administrative Law Judge: Pursuant to California Revenue and Taxation Code (R&TC) section[1] 19045, Paul B. Thompson and Kathleen D. Thompson (appellants) appeal an action by the Franchise Tax Board (FTB) in proposing assessments of additional tax and penalties for the taxable years 1999, 2000, 2001, and 2002 (the "taxable years at issue"). For 1999, FTB proposed additional tax of $68,955.00, a noneconomic substance (NEST) penalty of $27,582.00, and an interest-based (IB) penalty of $43,740.62. For 2000, FTB proposed additional tax of $80,477.00, a NEST penalty of $32,191.00, and an IB penalty of $40,608.91. For 2001, FTB proposed additional tax of $124,802.00, and a NEST penalty of $49,921.00, and an IB penalty of $47,804.87. For 2002, FTB proposed additional tax of $118,639.00, and a NEST penalty of $47,456.00, and an IB penalty of $35,568.09.

Office of Tax Appeals (OTA) Administrative Law Judges Tommy Leung, Neil Robinson, and John O. Johnson held an oral hearing for this matter in Sacramento, California,

[1] All section references are to statutes and regulations operative for the 1999, 2000, 2001, and 2002 taxable years.

on August 26, 2019. After the parties submitted their post-hearing briefs, the record was closed on August 30, 2019, and the matter submitted for decision.

ISSUES

1. Whether the Notices of Proposed Assessment (NPAs) for the taxable years at issue were timely.
2. Whether the structure implemented by appellant-husband, which involved the payment or accrual of employee leasing fees by an operating company, to an S corporation management company owned by an Employee Stock Ownership Plan ("ESOP"), and the deduction of such payments by the operating company, had sufficient business purpose and economic substance to be respected for tax purposes; if not, whether the income was properly allocable to the individual taxpayers or to the operating corporation that paid the management fees.
3. Whether the NEST penalty as provided by R&TC section 19774 is applicable.
4. Whether the IB penalty for a potentially abusive tax shelter as provided by R&TC section 19777 is applicable.

FACTUAL FINDINGS

A. Formation of Entities

1. On May 15, 1991, appellant-wife incorporated West Bay Builders, Inc. (WBB). According to WBB's tax returns for the years ending May 31, 1999, May 31, 2000, and May 31, 2001, appellant-husband owned 100 percent of the outstanding stock of WBB.
2. On December 13, 1996, appellant-husband incorporated Thompson & Thompson Consulting, Inc. (TT Consulting) and became a 50 percent owner. Appellant-husband's brother, Peter, was the other 50 percent owner of TT Consulting. TT Consulting had two employees: appellant-husband and Peter. According to appellants, TT Consulting charged WBB in return for construction estimating, engineering, and promotional services.
3. On March 8, 1999, WBB Management, Inc. (WBBM) was incorporated, and elected to be treated as an S corporation for tax purposes. WBBM replaced TT Consulting and WBBM "was formed to take advantage of [the] ESOP structure now allowed by the Taxpayer Relief Act of 1997." Although WBBM was authorized to issue up to 1,000,000

shares of stock, WBBM only issued 2,000 shares for $10,000. Appellant-husband was WBBM's sole employee at the time of incorporation. Appellant-husband purchased the 2,000 outstanding shares of stock for $10,000, and became WBBM's sole shareholder and owner. WBBM and WBB shared the same office address.

4. On March 8, 1999, WBBM adopted an ESOP. Appellant-husband used American Qualified Plans (AQP) to form and administer the ESOP. According to FTB, AQP, as the administrator, guaranteed that the IRS would approve the plan and, if the IRS did not approve of the plan, AQP would refund all fees incurred. According to the webpage print out from AQP's website which states: "Tailored to your specific company requirements AQP will provide all of the documentation necessary to design and install an ESOP . . . AQP prepares the IRS application for a Determination Letter and works directly with the IRS Employee Plans Division on the approval of your plan and trust. AQP guarantees a favorable determination approval or all costs incurred will be refunded." AQP also offered annual administration services related to the ESOP. The ESOP received a favorable determination letter from the IRS on or about August 29, 2001, stating that the ESOP qualified under Internal Revenue Code (IRC) section 401(a). The IRS subsequently revoked the ESOP's qualified status in 2008.

5. On March 8, 1999, appellant-husband sold his 2,000 shares of stock in WBBM to the ESOP. Appellant-husband was the sole participant of the ESOP at its formation and during the taxable years at issue, and the WBBM ESOP allocated 100 percent of the WBBM stock to appellant-husband's ESOP account.

6. After 2002, Mr. Frederick Joseph Hass participated in the ESOP. Mr. Hass' participation was limited to cash allocations to his ESOP account.

7. When the ESOP first acquired the WBBM stock, no other WBBM employee had an opportunity to have the WBBM ESOP allocate stock to their accounts, as WBBM did not have any additional shares of stock to allocate other than the 2,000 shares allocated for appellant-husband's benefit.

8. A Simplified Employer Pension (SEP) was set up for the exclusive benefit of all employees.

B. Employment Leasing Agreements

9. WBB entered into an employee leasing agreement with WBBM which had a stated effective date of April 1, 1999. According to the employee leasing document, WBBM agreed to lease its employees to WBB. WBB agreed to provide WBBM "information on the duties of the job to be filled by" WBBM.[2] For 1999, WBB agreed to pay WBBM $960,000 in two payments delivered on a date agreed upon between the parties and any additional compensation for incentive, bonuses and increased workload may be paid as negotiated between the parties. For any subsequent years in which this agreement remained in effect, the parties agreed that WBBM would be compensated at a rate agreed upon in writing by WBBM and WBB. The document lists appellant-husband as both representative of WBBM and WBB. In addition, the document lists the same address for both WBBM and WBB.
10. An employee leasing agreement between WBBM and WBB with a stated effective date of January 1, 2000, provided that WBBM would be compensated at a rate of $3,218,000 during the first year of the agreement and at a rate agreed upon in writing during the subsequent years of the agreement. WBB agreed to provide WBBM "information on the duties of the job to be filled by" WBBM.[3] The document lists appellant-husband as both representative of WBBM and WBB. In addition, the document lists the same address for both WBBM and WBB.
11. According to an undated brochure titled "WBB Management Construction Employee Staffing and Leasing," WBBM provided temporary, direct hire, and on-site construction employee solutions.

C. Valuations

12. For purposes of determining the fair market value of the 2,000 shares of WBBM stock sold to the ESOP, AQP performed a valuation of WBBM as of April 1, 1999, and determined that the 2,000 shares were valued at $10,000. AQP stated that appellant-husband was WBBM's sole employee. AQP stated that, all of the earnings of WBBM would be allocated to the ESOP and would be allocated to appellant-husband's ESOP

[2] There was no written employment agreement between appellant-husband and WBBM.

[3] There was no written employment agreement between appellant-husband and WBBM.

account as appellant-husband was the sole employee. AQP noted that the income anticipated by the ESOP was to be derived from the management services of appellant-husband as the sole employee of WBBM. AQP further noted that an unrelated person should not expect the same value for the shares of stock because it "is not reasonable to assume . . . that the sole employee would be motivated to divest himself of some portion of these personal service earnings for the benefit of some third-party passive investor in the corporation."

13. The valuation of WBBM as of December 31, 1999, stated that the 2,000 shares of WBBM was valued at $509,958 based on projected earnings. AQP noted that WBBM continued to contract the services of appellant-husband to WBB. AQP stated that, for the taxable year ending December 31, 1999, WBBM had a total income of $960,000 derived from consulting and business services to WBB. AQP noted that appellant-husband was WBBM's only employee.
14. In the valuation of WBBM as of December 31, 2000, AQP stated that WBBM's 2,000 shares of stock was valued at $2,173,613 based on projected earnings. AQP also noted that the company's balance sheet was extremely strong with total assets of $1,480,145. AQP stated that WBBM continued to lease the services of appellant-husband to WBB and appellant-husband was WBBM's only employee. AQP noted that WBBM had a total income of $3,217,643 derived from consulting and business services to WBB. According to WBBM's Employee Census as of December 31, 2000, there were no new employees.
15. In the valuation of WBBM as of December 31, 2001, AQP stated that WBBM's 2,000 shares of stock was valued at $3,721,706 based on projected earnings. AQP noted that the company's balance sheet was extremely strong with total assets of $2,778,496. AQP also noted that WBBM had a total income of $4,423,774 derived from consulting and business services to WBB. AQP noted that appellant-husband was the only employee of WBBM and the only participant of the ESOP.
16. In the valuation of WBBM as of December 31, 2002, AQP stated that WBBM's 2,000 shares of stock was valued at $3,302,703 based on projected earnings. AQP noted that the company's balance sheet was extremely strong with retained earnings of $3,860,113. AQP also noted that WBBM had total income of $5,724,257 derived from consulting and business services to WBB. AQP noted that appellant-husband was the only employee of

WBBM and the only participant of the ESOP. According to WBBM's Employee Census for the plan year ending December 31, 2002, appellant-husband also represented that he had $1,150,000 in annual compensation.

D. Tax Returns

17. During the taxable years at issue, WBB deducted amounts allegedly paid to WBBM for appellant-husband's purported services to WBB. Since the ESOP was the sole shareholder of WBBM, WBBM's income was allocated to the ESOP for income tax purposes.
18. On WBB's 1999 California tax return (Form 100),[4] WBB reported total income of $3,002,410 and total deductions of $2,774,231, for net income of $228,179. WBB reported no deductions for pension, profit-sharing plans, or similar types of expenses.
19. On WBB's 2000 Form 100, WBB reported total income of $4,318,292 and total deductions of $3,621,246, for net income of $697,046. WBB reported no deductions for pension, profit-sharing plans, or similar types of expenses.
20. On WBB's 2001 Form 100, WBB reported total income of $2,345,248 and total deductions of $2,069,719, for a net income of $275,529. WBB reported no deductions for pension, profit-sharing plans, or similar types of expenses.
21. On WBB's 2002 Form 100, WBB reported total income of $2,914,230 and total deductions of $2,417,598, for net income of $496,632. WBB reported no deductions for pension, profit-sharing plans, or similar types of expenses.
22. On WBBM's 1999 California tax return (Form 100S), WBBM reported total income of $960,000 and total deductions of $297,717, for ordinary income of $662,283. Of the deductions, WBBM deducted $275,000 for compensation of officers (appellant-husband) and $13,000 in pension, profit-sharing, or similar plans. According to the ESOP's Schedule K-1 from WBBM for 1999, the ESOP's pro-rata share of WBBM's ordinary income as a 100 percent shareholder was $662,283.
23. On WBBM's 2000 Form 100S, WBBM reported total income of $3,217,643 and total deductions of $2,493,109, for ordinary income of $724,534. Of the deductions, WBBM deducted $300,000 for compensation of officers (appellant-husband), $1,712,131 in

[4] WBB's fiscal year period was June 1 of the tax year through May 31 of the following year.

salary and wages, and $172,115 for contributions to pension plans, profit sharing plans, and similar plans. WBBM reported retained earnings of $683,923 at the beginning of the taxable year and $1,470,145 at the end of the taxable year. As the sole shareholder of WBBM, the ESOP was allocated 100 percent of WBBM's income of $724,534.[5]

24. On WBBM's 2001 Form 100S, WBBM reported total income of $4,424,049 and total deductions of $3,185,966, for ordinary income of $1,238,083. Of the deductions, WBBM deducted $375,000 for compensation to officers (appellant-husband), $2,198,700 for salaries and wages, and $206,107 for contributions to pension plans, profit sharing plans, and similar plans. As the sole shareholder of WBBM, the ESOP was allocated 100 percent of WBBM's income of $1,238,083.

25. On WBBM's 2002 Form 100S, WBBM reported total income of $5,725,799 and total deductions of $4,624,902, for ordinary income of $1,100,897. Of the deductions, WBBM deducted $1,150,000 for compensation to officers (appellant-husband), $2,663,086 for salaries and wages, and $232,680 for contributions to pension plans, profit sharing plans, and similar plans. WBBM reported retained earnings of $2,768,496 at the beginning of the taxable year and $3,860,113 at the end of the taxable year. As the sole shareholder of WBBM, the ESOP was allocated 100 percent of WBBM's income of $1,100,897.

26. The ESOP's 1999 Form 5500 reported one active participant, net income of $522,960, and its assets included employer securities of $509,960. In addition, WBBM contributed $13,000 to the ESOP which was allocated to appellant-husband's ESOP account.

27. The ESOP's 2000 Form 5500 reported one active participant, net income of $1,663,653, and its assets included employer securities of $2,173,613.

28. The ESOP's 2001 Form 5500 reported one active participant, net income of $1,573,593, and its assets included employer securities of $3,721,706. In addition, WBBM contributed $25,500 to the ESOP which was allocated to appellant-husband's ESOP account.

29. The ESOP's 2002 Form 5500 reported one active participant, a net loss of $427,284 and its assets included employer securities of $3,302,703.

[5] The record also contains WBBM's federal tax returns for 2000, 2001, and 2002.

E. Federal Audit

30. In 2005, the IRS began an audit of the ESOP's qualified status under IRC section 401(a). According to the Final Revocation Letter dated November 12, 2008, the IRS determined that appellant-husband owned 100 percent of the stock of WBB Construction, Inc. (WBBC) and, since WBBC owned 100 percent of WBB, appellant-husband was deemed to own 100 percent of WBB. The IRS also determined that, since the ESOP owned 100 percent of the stock of WBBM and appellant-husband was the sole participant of the ESOP holding WBBM stock, appellant-husband was deemed to own 100 percent of WBBM. As appellant-husband owned more than 80 percent of all three corporations, WBBM, WBBC, and WBB, the three corporations were determined to be a brother-sister controlled group. The IRS determined that appellant-husband was a highly compensated employee of the controlled group and, while appellant-husband was covered by the ESOP, none of the non-highly compensated employees of the controlled group were covered by the ESOP. The IRS noted that appellant-husband's ESOP account received an allocation of employer stock from the ESOP in 1999. The IRS further noted that appellant-husband's ESOP account received a cash allocation from the ESOP for 1999, 2001, 2003, and 2004. The IRS determined that, since none of the non-highly compensated employees of the controlled group received a benefit in any year, the ESOP violated the coverage requirements of IRC section 410(b).[6] The IRS determined that the ESOP was disqualified for plan years ending December 31, 1999, and for all subsequent plan years.

31. The IRS issued notices of deficiency to appellants for the 2002, 2003, and 2004 taxable years.[7] Appellants contested the federal determinations in the United States Tax Court (Tax Court). During the Tax Court proceedings, appellants agreed that the ESOP was not qualified. On January 20, 2012, appellants entered into a Closing Agreement on Final Determination Covering Specific Matters with the IRS. Appellants agreed that the ESOP was not qualified and that they would not participate in an identical or substantially

[6] IRC section 410(b) generally requires that an ESOP benefit a broad range of employees as opposed to only a select group of executive employees. An ESOP generally may not be aggregated with another plan for purposes of demonstrating compliance with these requirements. (Treas. Reg. § 1.410(b)-(7)(c)(2).)

[7] The IRS did not issue proposed deficiency notices to appellants for the 1999, 2000, and 2001 taxable years.

similar transaction in the future. For the 2002 taxable year, appellants agreed to a deficiency in federal income tax due of $795,062 (based on appellant-husband's vested accrued benefit in the WBBM ESOP of $1,999,753) and a federal accuracy-related penalty of $79,506. For the 2003 taxable year, appellants agreed to a deficiency in federal income tax due of $356,020 and a federal accuracy-related penalty of $35,602. For the 2004 taxable year, appellants agreed to a deficiency in federal income tax due of $301,933 and a federal accuracy-related penalty of $30,193. In addition, on January 20, 2012, WBBM and the IRS agreed that the ESOP was not qualified under IRC section 401(a) for the plan year ending December 31, 1999, and for all subsequent years. As a result, the ESOP was never a qualified ESOP.

32. According to appellants, the vested accrued benefit of appellant-husband's WBBM ESOP account was $0 (0% vested), $437,323 (20% vested), $1,006,760 (40% vested), and $495,671 (60% vested) for the 1999, 2000, 2001, and 2002 taxable years, respectively, for a total of $1,939,754; this total is $59,999 less than the $1,999,753 agreed to by appellants in their 2012 IRS closing agreement.

33. The IRS also entered into a Closing Agreement with Mr. Hass in 2012, which stated that Mr. Hass is not a highly compensated employee, he is not the trustee or administrator of the ESOP, and he is permitted to roll over his vested account balance in the ESOP to an eligible retirement plan without triggering certain federal income and excise taxes. The Closing Agreement did not state when Mr. Hass began participating in the ESOP, but he later confirmed in his declaration that he joined the ESOP in 2003.

F. California Audit

34. According to FTB, appellants filed their 1999, 2000, 2001, and 2002 California tax returns on October 15, 2000, October 15, 2001, October 15, 2002, and October 15, 2003, respectively.

35. On June 15, 2004, WBBM was notified that it was under audit. On June 24, 2004, appellant-husband signed a power of attorney authorizing Cary Gaidano to represent WBBM in the FTB audit. During the audit of WBBM, FTB determined that the transactions at issue were entered into for the sole purpose of tax avoidance and issued an Audit Issue Presentation Sheet Number 1 dated November 17, 2006. In addition, FTB issued a position letter to appellant-husband dated February 6, 2007, outlining the tax

consequences of the abusive transaction involving WBBM and the ESOP. FTB's Audit Issue Presentation Sheets dated November 17, 2006, and July 2, 2007, described FTB’s position that the structure used by appellants is substantially similar to the structure identified by the IRS as a Management S Corporation ESOP Transaction, IRS Announcement 2005-80, and the tax consequences to appellant-husband. FTB notified appellants that it recommended allocating the income of WBBM to appellant-husband and imposing NEST and IB penalties on the NPAs. After an extensive examination, FTB determined that the transactions at issue did not have economic substance and reallocated WBBM’s income for the 1999, 2000, 2001, and 2002 tax years to appellant-husband.

36. FTB issued NPAs for the taxable years at issue on November 13, 2007. The NPA for the 1999 taxable year proposed to increase appellants’ California taxable income from $433,346 to $1,174,870, and proposed additional tax of $68,955. The NPA for the 2000 taxable year proposed to increase appellants’ California taxable income from $390,468 to $1,255,890, and proposed additional tax of $80,477. The NPA for the 2001 taxable year proposed to increase appellants’ California taxable income from $71,577 to $1,436,837, and proposed additional tax of $124,802. The NPA for the 2002 taxable year proposed to increase appellants’ California taxable income from $1,145,928 to $2,386,150, and proposed additional tax of $118,639. Each of the NPAs for the taxable years at issue also proposed the imposition of NEST and IB Penalties.

37. Appellants protested the NPAs. After review, FTB issued Notices of Action for the taxable years at issue on June 17, 2014, to appellants affirming the audit determination. Appellants requested FTB’s Chief Counsel to waive the NEST penalty, which was denied.

38. Records potentially relevant to appellants’ appeal were destroyed in a warehouse fire on May 16, 2008.

DISCUSSION

Issue 1 - Whether the Notices of Proposed Assessment for each tax year were issued timely.

R&TC section 19057(a) provides generally that every NPA shall be mailed to the taxpayer within four years after the return is filed. An exception to this general rule is found in R&TC section 19755.[8]

R&TC section 19755(a) provides that if a proposed assessment is related to "an abusive tax avoidance transaction, as defined in subdivision (c) of [R&TC] Section 19753," a notice of proposed deficiency may be mailed up to eight years after the filing of the tax return. R&TC section 19755 is applicable to tax returns filed on or after January 1, 2000.

R&TC section 19753(c) defines an "abusive tax avoidance transaction" (ATAT) as "a plan or arrangement devised for the principal purpose of avoiding tax." It further states that "[a]busive tax avoidance transactions include, *but are not limited to*, 'listed transactions' as described in subdivision (a) of [R&TC] Section 18407." (Emphasis added.) R&TC section 18407(a)(4) provides that "a 'listed transaction' includes any transaction that is the same as, or substantially similar to, a transaction specifically identified by the Secretary of the Treasury under Section 6011 of the Internal Revenue Code for federal income tax purposes or by the [FTB] under this section for California income or franchise tax purposes, as a tax avoidance transaction including deductions, basis, credits, entity classification, dividend elimination, or omission of income . . . ."

The party asserting a statute of limitations defense has the burden of proving the defense. (*Adler v. Commissioner* (1985) 85 T.C. 535, 540; See also *Amesbury Apartments, Ltd. v. Commissioner* (T.C. 1990) 95 T.C. 227, 240-241; *Heckman v. Commissioner*, T.C. Memo. 2014-131.) Unsupported assertions are not sufficient to satisfy an appellant's burden of proof. (*Appeal of Aaron and Eloise Magidow* (82-SBE-274) 1982 WL 11930.) An appellant's failure to produce evidence that is within his or her control gives rise to a presumption that such evidence is unfavorable to his or her case. (*Appeal of Don A. Cookston* (83-SBE-048) 1983 WL 15434.) In the absence of credible, competent, and relevant evidence showing an error in the

[8] Another exception to this general rule is provided in R&TC section 19058. R&TC section 19058 provides that, if a taxpayer "omits from gross income an amount properly includable therein which is in excess of 25 percent of the amount of gross income stated in the return, a notice of a proposed deficiency assessment may be mailed to the taxpayer within six years after the return was filed." As discussed below in Issue 2, since we believe appellants were engaged in an abusive tax avoidance transaction, we need not discuss R&TC section 19058.

FTB's determinations, FTB's determinations will be upheld. (*Appeal of Oscar D. and Agatha E. Seltzer* (80-SBE-154) 1980 WL 5068.)

Appellants timely filed their California tax returns for the taxable years at issue by the October 15 extended due date. FTB issued the NPAs for the years at issue on November 13, 2007.

Appellants assert that, for purposes of the statute of limitations, FTB bears the burden of proof in demonstrating that the principal purpose of the transaction is to avoid taxes. Appellants cite R&TC section 19180 which provides that FTB bears the burden of proof for imposing penalties under R&TC sections 19177, 19178, and 19179. Appellants' reliance on this provision is misplaced as that provision is limited to those specific penalties.[9] Appellants bear the burden of proof in establishing any affirmative defenses regarding the statute of limitations. (*Adler v. Commissioner*, *supra*.)

Appellants contend that the transaction was not a listed transaction and therefore the eight-year statute of limitations is inapplicable. We note that R&TC section 19753(c) specifically provides that ATATs are not limited to listed transactions. Therefore, if the transaction was a plan or arrangement devised for the principal purpose of avoiding tax, the transaction is an ATAT.

Appellants assert that the formation of WBBM and the ESOP was intended to provide incentives to retain key employees. As discussed further below in Issue 2, the evidence demonstrates that the plan was primarily formed to shift taxable income to a tax favored entity to the benefit of appellant-husband and the formation of the ESOP had no valid business purpose. This determination is consistent with the IRS's determination disqualifying the ESOP *ab initio*. The fact that the IRS did not allow appellants to correct the ESOP further supports a

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[9] Appellants also assert that FTB erred in applying R&TC section 19775 retroactively to the years on appeal, relying on *Franchise Tax Board v. Superior Court of San Francisco County* (*Quellos Group LLC, Real Party in Interest*) (2013) 221 Cal.App.4th, 164 Cal. Rptr. 3d 752 (*Quellos*). In *Quellos*, the court examined an uncodified section of the law enacting tax shelter penalties, which stated that the law would apply with respect to any penalty assessed on or after January 1, 2004, on any return for which the statute of limitations had not expired. As the penalty imposed on promoters was not assessed on a taxpayer's return, the court held that the uncodified section did not apply to the promoter penalty. The court examined the uncodified language as there was no specific statutory language with regard to the retroactive application of the promoter penalty.

As the current appeal involves proposed penalties imposed against the taxpayers on the basis of an examination of their tax returns, the *Quellos* decision is not applicable. Further, since R&TC section 19755 specifically provides that assessments on taxpayers related to ATATs may be mailed within eight years of the date the tax return is filed and applied to any return filed on or after January 1, 2000, the statute was not applied retroactively.

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finding that appellants were engaged in an ATAT.[10] We find that the ESOP was devised for the principal purpose of avoiding tax. Therefore, appellants engaged in an ATAT.

Accordingly, R&TC section 19755 extended the statute of limitations for the taxable years at issue to at least October 15, 2008. Thus, since the NPAs in question were issued on November 13, 2007, they were not time-barred.

Issue 2 - Whether the management S corporation ESOP structure lacked economic substance (and is thus an ATAT) and, if so, whether FTB erred in reallocating income originally reported to the ESOP to appellant-husband on the basis that appellants' transactions involving a claimed deduction of employee leasing fees payable or paid to the S corporation management company owned by the ESOP lacked economic substance.

FTB's determination is presumed correct and the taxpayer has the burden of proving the determination to be wrong. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Michael E. Myers* (2001-SBE-001) 2001 WL 37126924.) In determining whether a transaction lacks economic substance, courts have generally focused on the following principles: (1) whether the taxpayer has demonstrated a business purpose for engaging in the transaction other than tax avoidance; and (2) whether the taxpayer has shown that the transaction had economic substance beyond the creation of tax benefits. (*Casebeer v. Comm'r* (9th Cir. 1990) 909 F.2d 1360, 1363 (*Casebeer*); *Appeal of James A. Alyn and Lisa E. Alyn* (2009-SBE-001) 2009 WL 2340393 (*Alyn*).) The business purpose factor is a subjective analysis of the taxpayer's intent in entering the transaction whereas the economic substance factor is an objective analysis of whether the transaction had any practical economic effects other than the creation of tax losses. (*Casebeer, supra*.) "The application of the 'business purpose' prong is a subjective test, whereas the application of the 'economic substance' prong is an objective test." (*Ibid.*) The business purpose prong and the economic substance prong are "precise factors" that need to be weighed to determine whether the transaction had any practical economic effects other than the creation of tax benefits. (*Ibid.*; *Alyn*, *supra*.)

The transaction to be analyzed is the one that gave rise to the alleged tax benefit. (*Coltec Industries, Inc. v. United States* (Fed. Cir. 2006) 454 F.3d 1340, 1356 (*Coltec*).) A lack of

[10] The IRS offered settlement initiative programs for certain taxpayers to correct problems with ESOP formation. The IRS generally permitted taxpayers to enter into such programs unless the plan or plan sponsor is directly related to an ATAT and the failure being corrected is directly or indirectly related to an ATAT.

economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance. (*Id.* at p. 1355.) Additionally, the taxpayer bears the burden of proving that the transaction has economic substance (*ibid.*), and whether the taxpayer meets the economic substance test is a factual finding (*id.* at p. 1365).

The business purpose factor involves an examination of the subjective factors that motivated the taxpayer to engage in the transaction at issue. (*Casebeer, supra,* 909 2d at p. 1366.) "The business purpose factor often involves an examination of the subjective factors which motivated a taxpayer to make the transaction at issue." (*Bail Bonds by Marvin Nelson, Inc. v. Comm'r* (9th Cir. 1987) 820 F.2d 1543, 1549.)

The economic substance factor looks beyond the form of the transactions to the objective substantive effect of the transactions. The question is not one of whether the taxpayer believed the transaction was capable of creating a profit or affecting the taxpayer's financial situation, but whether the transaction in fact objectively was a transaction capable of either of those two possibilities. (*Jade Trading, LLC v. United States* (Fed. Cl. 2007) 80 Fed. Cl. 11 at pp. 47, 48; *Coltec, supra,* 454 F.3d at p. 1355.) "To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress." (*Commissioner v. Court Holding Co.* (1945) 324 U.S. 331, 334.)

In *United States v. A. Blair Stover* (W.D. Mo. 2010) 731 F.Supp.2d 887 (*affirmed* by *United States v. A. Blair Stover* (8th Cir. 2011) 650 F.3d 1099 (*Stover*), the federal district court held that an accountant was enjoined from promoting and selling a certain tax structure involving an operating company that formed an S corporation management company, which, in turn, created an ESOP that owned the management company's stock. The court found that the same person(s) who owned the operating and management companies were also the only beneficiaries of the ESOP. (*Ibid.*) In addition, the management fees paid by the operating company obtained an indefinite deferral of income taxation as the income to the management company was not taxed because it made an election under subchapter S, and an ESOP's income is not subject to taxation. (*Ibid.*) The operating company gained a deduction of the management fees and those fees were not taxed until the money was distributed from the ESOP. (*Ibid.*)

The *Stover* court noted that the operating company and the management company were part of a controlled group because the same persons owned all the stock of both companies.

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(*Stover*, *supra*.) The owners of the corporations were deemed to be key employees and the ESOP favored them because the other employees in the operating company were not permitted to participate in the plan. (*Ibid*.) The federal district court determined that these ESOP and S corporation arrangements lacked a business purpose. (*Ibid*.) On appeal, the United States Court of Appeals for the Eighth Circuit affirmed the lower court's determination that the arrangements constituted abusive tax shelters. (*Ibid*.)

We will apply the two-prong test of *Casebeer*, *supra*, and *Alyn*, *supra*, to determine whether the stated form of appellants' transaction reflects economic substance. We will consider whether appellants have shown (1) a subjective business purpose for forming the WBBM ESOP and causing WBBM and WBB to enter into the employment leasing agreement; and (2) the objective economic substance of the transaction.

Business Purpose

Appellants assert the arrangement was the result of the need to stabilize WBB's business after appellant-husband's brother (Peter) split from WBB. Appellants contend that appellant-husband incorporated WBBM to replace TT Consulting and to maximize his ability to attract and keep key personnel as a result of the split with Peter and the loss of approximately 12 key employees to Peter's new company. Appellants did not provide sufficient evidence to support this assertion.[11] While appellants claim that use of a separate management company is prevalent in the construction industry, appellants' own witness testified at the hearing that only about half of his twenty-five construction clients employed the use of a separate management company. Furthermore, although this contention may address the reason for forming WBBM, it fails to address the purported business purpose for forming the ESOP and causing WBBM to enter into the employee leasing agreements with WBB.

Appellants assert that the business purpose of forming the ESOP for WBBM was to provide incentives to retain key employees. Appellants assert that appellant-husband intended to transfer employees from WBB to WBBM so that WBBM would provide administrative services to other contractors. However, none of WBB's employees were participants in the ESOP and appellant-husband was the sole participant in the ESOP when the ESOP allocated the WBBM

[11] Appellants assert that relevant records are no longer available. We note that FTB's audit on WBBM began in June of 2004, well before the warehouse fire that occurred on May 16, 2008. In any event, a taxpayer's failure to retain substantiating evidence cannot shift the burden of proof to FTB. (See, e.g., *Moylan v. Comm'r*, T.C. Memo. 1999-338, p. 4; *Priestly v. Comm'r*, T.C. Memo. 2003-267, pp. 10-11.)

stock to his account during the taxable years at issue. Since appellant-husband was the sole participant in the ESOP, substantially all of the actual cash and value of the ESOP went to appellant-husband.

Appellants did not provide persuasive evidence to support their assertion that WBB's employees initially transferred to WBBM, but then returned to WBB in 2002 due to their preference for the SEP-IRA accounts at WBB. Curiously, the W-2 in appellants' Exhibit 47 indicates that the named employee did not participate in any retirement plan between 1998 and 2000. Rather, the record shows that appellant-husband was the sole employee of WBBM and the sole participant in the ESOP during the taxable years at issue. Appellant-husband represented that he was the only WBBM employee when AQP made its valuation of the WBBM stock. Even if appellants could establish that the employees returned to WBB because they preferred the retirement option at WBB, appellants have not provided any explanation of why, if appellant-husband intended to retain key employees of WBB, he did not form the ESOP for WBB instead of forming the ESOP for WBBM.

In addition, participation by other employees in the ESOP occurred after the taxable years at issue. The AQP valuations and the ESOP's Forms 5500 reported only one participant during the taxable years at issue. Further, Mr. Hass' participation in the ESOP was limited to discretionary cash allocations. Such limited participation pales in comparison to the benefits enjoyed by appellant-husband since appellant-husband received the appreciation in the value of the WBBM stock when it was allocated to his ESOP account in 1999.

Appellants further assert that, by forming WBBM and causing WBB to enter into the employment leasing agreements with WBBM, WBB would be less expensive for employees to acquire WBB stock. Appellants did not provide persuasive evidence that appellant-husband intended to offer WBB employees the opportunity to buy WBB stock during the taxable years at issue. As such, the arrangement did not effectuate appellants' stated business purpose of providing incentives to retain key WBB employees.

Moreover, the IRS determined that the ESOP was not qualified under IRC section 401(a) because the non-highly compensated employees of the WBBC-WBB-WBBM controlled group were excluded. Appellants admit that appellant-husband did not widen WBBM's role and function due to the "the uncertainty and chilling effect" created by IRC section 409(p), which

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suggests that appellant-husband's sole purpose in forming the ESOP was for its tax benefits.[12] We find that appellant-husband's actions are inconsistent with his asserted intention of creating a structure to allow other employees to hold stock and share in WBB's and WBBM's success.

Further, federal courts,[13] Congress (via enactment of IRC section 409(p) in 2001[14]), and the IRS[15] have concluded that similar transactions involving management S corporation ESOP structures lacked a valid business purpose. Similar to the transaction in *Stover*, appellant-husband owned both the operating company, WBB, and the management company, WBBM, and he was the sole beneficiary of the ESOP's most valuable asset, the stock in WBBM. The employee leasing fees paid by WBB obtained an indefinite deferral of income taxation as WBBM was an S corporation whose sole shareholder was the ESOP, and the ESOP's income was not subject to taxation. Thus, appellants did not show that the transaction had a valid business purpose.

Economic Substance

The formation of the ESOP and the pass-through thereto of the income from WBBM's employee leasing agreements gave rise to the tax benefit. The record demonstrates that the only individual who could benefit from the formation of the ESOP was appellant-husband since he was the sole participant of the ESOP during the taxable years at issue. As for Mr. Hass' subsequent participation in the ESOP, his participation appears to be limited to discretionary cash allocations after 2002. Mr. Hass did not benefit from any appreciation in the value of WBBM stock since the stock had already been allocated to appellant-husband's account in the ESOP and there is no evidence to suggest that WBBM issued any additional shares of stock. In addition, the fact that the value of WBBM did not take into account its retained earnings suggests

[12] This is further supported by an email discussion between appellants' accountant and their surety stating that the plan was all about tax savings and appellants' CPA "filled . . . their heads with great tax reduction ideas." Further, the emails stated as long as "mass dollars were not distributed to the ESOP," the surety would be willing to continue insuring the company, which suggests that while income was allocated to the ESOP for tax purposes, appellants never intended to distribute the full value of the company to the ESOP. In addition, according to a document provided by appellants' CPA, WBBM was formed to take advantage of the ESOP structure allowed by the Taxpayer Relief Act of 1997.

[13] See *Stover*, *supra*, 731 F.Supp.2d 887; *Weekend Warrior Trailers*, *Inc. v. Commissioner*, T.C. Memo. 2011-105.

[14] Pub.L. No. 107-16, 115 Stat. 38, § 656(a).

[15] See Exhibit BB and IRS Ann. 2005-80, 2005-2 C.B. 967.

that while the ESOP received a pro rata share of WBBM's income for tax purposes, the ESOP did not actually receive an equivalent amount in distributions.

The employee leasing agreements between WBB and WBBM shifted income from WBB to WBBM with no apparent change in WBB's operations. Appellant-husband was still the owner of WBB and still performed services for WBB, but now as an employee of WBBM. WBBM and WBB shared the same office. Further, even the list of non-profit organizational clients which includes the contracts of "West Bay/WBBM" suggests that the two entities were one and the same. Appellants did not demonstrate that appellant-husband's role changed in any substantive way. WBBM's income from leasing appellant-husband's services to WBB was allocated to the ESOP. Appellant-husband was the beneficial owner of the WBBM stock since the stock was allocated to his ESOP account.[16] The fact that the IRS determination that the ESOP was disqualified and appellant-husband was deemed the owner of WBBM also supports this finding. The effect of the formation of the ESOP and the execution of the employee leasing agreements was to provide appellant-husband with a way to shift income from WBB to a tax-deferred entity for his own benefit.

Appellants also assert that the transaction had economic substance due to WBBM providing "pre-construction services" to non-profit organizational clients of WBB, who then billed WBBM for those services. Appellants rely on WBBM's brochure as evidence of the services offered by WBBM. The list of non-profit organizational clients does not indicate what types of services were provided or if WBBM was actually paid by these clients. Further, even if appellants demonstrated that WBBM provided services to, and was paid by, these clients, those billings have at most a *de minimis* economic effect. The AQP valuations show that this activity was not contemplated at the time of implementing the structure. According to the AQP valuations, the principal source of revenue for WBBM was derived from leasing out appellant-husband's services to WBB for the taxable years at issue.

Further, appellants did not provide persuasive evidence establishing that the amounts WBB paid to WBBM to retain appellant-husband's services were determined in an arm's length

[16] It appears that appellant-husband may have been the sole beneficiary of the amounts WBBM reported as pension contributions since appellant-husband was the sole employee of WBBM during the taxable years at issue. WBBM reported pension contributions of $13,000, $172,115, $206,107, and $232,680, for the 1999, 2000, 2001, and 2002 taxable years, respectively. The IRS determination also noted that appellant-husband received cash allocations in 1999 and 2001.

transaction. According to the employee leasing agreements and the AQP valuations, WBB paid leasing fees to WBBM of $960,000, $3,217,643, $4,423,774, and $5,724,257, for 1999, 2000, 2001, and 2002, respectively.[17] Appellants did not provide persuasive evidence of the type of services appellant-husband provided to WBB to support the amounts WBB purportedly paid to WBBM. Appellants did not provide any invoices or other similar documents that detail the amounts paid to WBBM. We find that these amounts merely reduced WBB's taxable income by shifting income away from WBB to WBBM and the ESOP. Accordingly, the transaction lacked economic substance.

Therefore, we find that appellants failed to demonstrate error in FTB's determination to reallocate the reported income from the ESOP to appellant-husband. However, we disagree with the method FTB used to make that allocation. FTB did not follow IRS practice and a Tax Court stipulated settlement document (Exhibits BB and JJ, respectively) even though it succeeded in having those documents admitted into the record over appellants' objections; instead, FTB decided to allocate all of the income from the employee leasing agreements to appellants without explaining why WBB, WBBM, and the ESOP should be ignored. Just because the transactions at issue lack economic substance does not necessarily mean WBB, WBBM, and the ESOP should be disregarded. (*See Moline Properties, Inc. v. Comm'r* (1943) 319 U.S. 436.) Moreover, as distinguished from other similar cases, WBB is not a pass-through entity. The income involved in this appeal was earned by WBB in corporate solution and, unlike many of the operating companies that engaged in management S corporation ESOP structures, did not make an S election for income tax purposes. Thus, while we agree with FTB that appellant-husband was engaged in an ATAT, we do not believe it was proper to allocate all of WBBM's income to him.

Exhibit BB is the IRS's public announcement of how it would treat these types of transactions (i.e., the value of the participant's vested accrued benefit in the ESOP is taxable),

[17] According to the employee leasing agreement which has a stated effective date of April 1, 1999, and the AQP valuation as of December 31, 2000, WBB agreed to pay WBBM $960,000 payable in two payments during the first year of the agreement and at a rate agreed upon in writing by the parties each year thereafter wherein the agreement remains in effect. According to the AQP valuation as of December 31, 2000, WBBM had a total income of $3,217,643 derived from the consulting and business services to WBB. Further, the employee leasing agreement between WBBM and WBB with a stated effective date of January 1, 2000, provided that WBBM would be compensated at a rate of $3,218,000 during the first year of that agreement. According to the AQP valuation as of December 31, 2001, WBBM had a total income of $4,423,774 derived from the consulting and business services to WBB. According to the AQP valuation as of December 31, 2002, WBBM had a total income of $5,724,257 derived from the consulting and business services to WBB.

and Exhibit JJ demonstrates the application of that treatment in the resolution it reached with appellants in 2012. For this reason, we decide to follow the IRS's approach and allocate income that appellant-husband ostensibly realized in the form of the vested accrued benefit in his ESOP account. We note that appellants' computation of that vested amount is less than the IRS's computation. To reconcile this, we will add the $59,999 difference to the 2002 taxable year because 2002 was the one taxable year which both the IRS and FTB audited.

Issue 3 - Whether the R&TC section 19774 NEST penalty is applicable.

R&TC section 19774(a) imposes a penalty for a noneconomic substance transaction 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 any portion for which the "relevant facts affecting the tax treatment of the item are adequately disclosed in the return or a statement attached to the return." (R&TC, § 19774(b)(1).) 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).)

Under R&TC section 19774(d)(1), once a penalty is imposed and the NPA is sent, only FTB's Chief Counsel "may compromise all or any portion of that penalty." R&TC section 19774(d)(3) specifies that "[n]otwithstanding any other law or rule of law, any determination under this subdivision may not be reviewed in any administrative or judicial proceeding."

For the reasons discussed above under Issue 2, the evidence shows that the transactions lacked economic substance and appellants did not demonstrate a valid nontax California business purpose for entering into those transactions. Appellants did not demonstrate with persuasive evidence that the formation of the ESOP had a valid business purpose. As for the employment leasing agreements between WBB and WBBM, appellant-husband continued to provide the same type of services to WBB. Appellants did not provide any persuasive evidence to show that the fees were actually paid by WBB to WBBM or that the fees were based on an arm's-length

transaction. The formation of the ESOP and pass-through of WBBM's income from the employee leasing fees to a tax-favored entity lacked any purpose other than to shelter a portion of WBB's income from taxation for the benefit of WBB's shareholder, appellant-husband.

Appellants contend that the NEST penalty should be reduced to 20 percent because the transaction was adequately disclosed on the tax returns of WBB, WBBM, and the ESOP. With regard to the ESOP's tax return, the ESOP only filed federal tax returns which are not generally provided to California. Further, appellants did not show that they provided the ESOP's federal tax returns to FTB with their California tax returns during the taxable years at issue.

With regard to the tax returns of WBB and WBBM, appellants disclosed that appellant-husband sold 2,000 shares of WBBM's stock to the ESOP and the ESOP was the sole shareholder of WBBM. Further, appellants disclosed that WBBM was in the employee leasing business. However, in order to adequately disclose the transaction, appellants would have needed to disclose the following additional facts on the returns: (1) appellant-husband was the only beneficiary and participant of the ESOP during the taxable years at issue; (2) appellant-husband was WBBM's sole employee; (3) appellant-husband previously provided similar services to WBB; and (4) WBBM's ESOP was required to include participation by its own employees as well as the employees of WBB and WBBC pursuant to IRC sections 401(a) and 410(b). Since these facts were not disclosed on the returns appellants filed with FTB, we find that the penalty shall not be reduced to 20 percent.

We hold that the 40-percent NEST penalty is applicable. However, because we reduced the amount of the under-reported taxable income, the total amount of the penalty should also be reduced accordingly. Although R&TC section 19774(d)(3) precludes review by any administrative or judicial proceeding of FTB's Chief Counsel's denial of appellants' request for relief from the imposition of the penalty, such a prohibition does not prevent us from adjusting the amount of the under-reported taxable income.

Issue 4 - Whether the IB penalty for a potentially abusive tax shelter as provided by R&TC section 19777 is applicable.

Under R&TC section 19777, a penalty of 100 percent of the interest that accrued prior to the date of the mailing of the NPA is imposed on a deficiency if FTB contacted the taxpayer regarding the use of a potentially abusive tax shelter. R&TC section 19777(b)(2) defines a potentially abusive tax shelter as an arrangement "of a type" which FTB or the IRS

determines by regulations as having a potential for tax avoidance or evasion. R&TC section 19777 applies to NPAs mailed after January 1, 2004, and for taxable years ending on or before December 31, 2004.

Former Treasury Regulation section 1.6011-4T provided, in part, that every taxpayer who participated, directly or indirectly, in a "reportable transaction" was required to disclose the transaction. A "reportable transaction" is defined as a "listed transaction" or an "other reportable transaction." (Former Treas. Reg. § 1.6011-4T(b).)

"Other reportable transaction" was identified as a transaction: (1) entered into after February 28, 2000; (2) which satisfied two of the six characteristics presented in the regulation; and (3) met "the projected tax effect test." [18] As relevant to this appeal, the characteristics include the following:

> …
>
> (B) The taxpayer has obtained or been provided with contractual protection against the possibility that part or all of the intended tax benefits from the transaction will not be sustained, including, but not limited to, recission rights, the right to a full or partial refund of fees paid to any person, fees that are contingent on the taxpayer's realization of tax benefits from the transaction, insurance protection with respect to the tax treatment of the transaction, or a tax indemnity or similar agreement (other than a customary indemnity provided by a principal to the transaction that did not participate in the promotion of the transaction to the taxpayer).
>
> …
>
> (E) The transaction involves the participation of a person that the taxpayer knows or has reason to know is in a Federal income tax position that differs from that of the taxpayer (such as a tax exempt entity or a foreign person), and the taxpayer knows or has reason to know that such difference in tax position has permitted the transaction to be structured on terms that are intended to provide the taxpayer with more favorable Federal income tax treatment than it could have obtained without the participation of such person (or another person in a similar tax position).
>
> …

(Former Treas. Reg. §§ 1.6011-4T(b)(3)(i)(B) & (E).)

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[18] We find that the requirements that the transaction be entered into on or after February 28, 2000, and the "projected tax effect" only implicate whether the amount or magnitude of the tax effect is sufficient to require reporting of the transaction, rather than implicating whether the transaction is of a "type" having the "potential" for tax avoidance. A transaction met the projected tax effect test, with respect to "other reportable transactions," if the taxpayer reasonably estimates the transaction will reduce its federal tax liability by $5 million in any single year or more than $10 million for multiple tax years. (Former Treas. Reg. § 1.6011-4T-(b)(4).)

The transactions at issue involved the participation of an ESOP. Appellant-husband acknowledged that, at the time of formation, he was the sole participant in the ESOP and allocated all of the outstanding stock in WBBM to his ESOP account. Further, the emails between appellant's CPA and surety reflect that appellants understood that the formation of the ESOP would result in tax benefits. Therefore, appellant-husband knew or had reason to know that the ESOP's tax position allowed the transactions at issue to be structured to provide appellant-husband with more favorable income tax treatment than he could have obtained without the participation of the ESOP.

In addition, the transactions at issue satisfy the contractual protections characteristic. (Former Treas. Reg. § 1.6011-4T(b)(3)(i)(B).) According to AQP's website, AQP would prepare the documentation to design and install an ESOP and work directly with the IRS to obtain approval of the ESOP. AQP guaranteed a favorable determination approval or it would refund all costs incurred. Appellant-husband was provided with contractual protection against the possibility that part or all of the intended tax benefits from the transaction will not be sustained since AQP agreed to return the fees if the IRS did not approve of the transaction.

Thus, appellants engaged in an arrangement "of a type" which has been determined by regulations as having a potential for tax avoidance or evasion. Further, FTB contacted appellants regarding the use of this potentially abusive tax shelter on February 6, 2007. In that letter, FTB outlined the tax consequences of the abusive transaction involving WBBM and the ESOP to appellants. FTB issued the NPAs for the taxable years at issue after January 1, 2004. Therefore, we hold that the IB penalty is applicable.

In reaching all of our holdings herein, we considered all arguments made by the parties (including the WBBM loans), and to the extent not mentioned above, we find them to be moot, irrelevant, inconclusive, or without merit.

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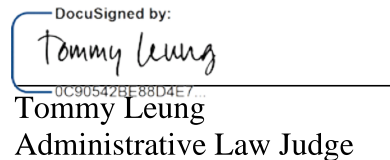
HOLDINGS

1. The NPAs for the taxable years at issue were timely.
2. The management S corporation ESOP structure was an ATAT; however, FTB erred in reallocating all of the income originally reported to the ESOP to appellant-husband, and its action in this regard is modified accordingly. The income allocated to appellant-husband shall be the vested accrued benefit of appellant-husband's WBBM ESOP account, equaling $0 for 1999, $437,323 for 2000, and $1,006,760 for 2001.
   To reconcile the difference between the IRS's and appellants' computation of appellant-husband's vested accrued benefit in his WBBM ESOP account, $59,999 shall be added to his 2002 vested accrued benefit for a total 2002 vested accrued benefit of $555,670.
3. The NEST penalty is applicable but is modified in accordance with the reduction of the amount of under-reported taxable income.
4. The IB penalty is applicable.

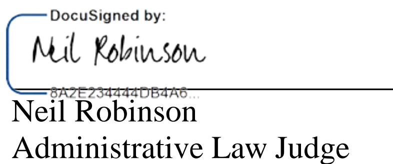
DISPOSITION

FTB's actions are modified in accordance with the opinion expressed herein.

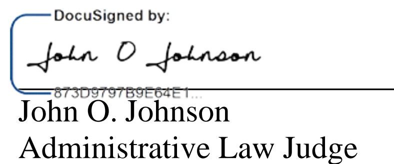


Tommy Leung
Administrative Law Judge

We concur:



Neil Robinson
Administrative Law Judge



John O. Johnson
Administrative Law Judge