OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18011377
P. THOMPSON AND K. THOMPSON	)
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	)

OPINION ON PETITION FOR REHEARING

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

T. LEUNG, Administrative Law Judge: On December 4, 2019, we issued an opinion (the Opinion) modifying the action of respondent Franchise Tax Board (FTB) proposing assessments of additional tax and penalties (NPAs) 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. In the Opinion, we held that:

1. The NPAs for the taxable years at issue were timely.
2. The management S corporation ESOP structure was an abusive tax avoidance transaction (ATAT); however, FTB erred in reallocating all of the income originally reported to the ESOP to appellant-husband, and its action in this regard was 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 Internal Revenue Service's (IRS) 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 was applicable but is modified in accordance with the reduction of the amount of under-reported taxable income.

4. The IB penalty was applicable.

Pursuant to California Revenue and Taxation Code (R&TC) section[1] 19048 and California Code of Regulations, title 18, section (Regulation) 30602, P. Thompson and K. Thompson (appellants) filed this petition for rehearing (PFR). Upon consideration of the matters stated therein, we find that appellants have not established good cause for a new hearing. (Cal. Code Regs., tit. 18, § 30604; *Appeal of Do*, 2018-OTA-002P.)

Regulation 30604(a)-(e) provides that a rehearing may be granted where one or more of the following grounds exists and the rights of the complaining party are materially affected: (1) an irregularity in the proceedings by which the party was prevented from having a fair consideration of its case; (2) an accident or surprise that occurred during the proceedings and prior to the issuance of the written opinion, which ordinary prudence could not have guarded against; (3) newly discovered, relevant evidence, which the party could not, with reasonable diligence, have discovered and produced prior to the issuance of the written opinion; (4) insufficient evidence to justify the written opinion, or the opinion is contrary to law; or (5) an error in law. (See also *Appeal of Do, supra*.) Appellants' PFR asserts the Opinion contained errors of fact and is contrary to law (i.e., ground four).

Specifically, appellants argue that Office of Tax Appeals made factual errors in finding that appellant-husband was an employee of West Bay Builders, Inc. (WBB) prior to joining WBB Management, Inc. (WBBM); the Reliance Surety emails were relevant because the emails were referring to another client of Mr. Gaidano, not appellants, WBB or WBBM, Mr. Gaidano was not a party to those emails, and the Reliance employees mentioned were not assigned to WBB/WBBM's account; and appellant-husband was WBBM's sole employee. Appellants

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

further contend that the Opinion was contrary to law because it relied on the IRS settlement; the NPAs were not timely; it improperly relied on the IRS closing agreements to make the ATAT determination and shifted the burden of proof to appellants; appellants were not the proper taxpayer; there was sufficient disclosure to reduce the NEST penalty; and the IB penalty was improperly imposed.

A PFR on the grounds of insufficient evidence should be granted only when, after weighing the evidence, we are convinced from the entire record, including reasonable inferences therefrom, that we clearly should have reached a different decision. (See Code Civ. Proc., § 657.) Likewise, a PFR on the ground that our decision was contrary to law cannot be granted unless we conclude that our disposition was erroneous as a matter of law. (*Tun v. Wells Fargo Dealer Services, Inc.* (2016) 5 Cal.App.5th 309, 323.)

Instead of trying to reconcile the conflicts in the record with their PFR, appellants continue to compromise their position by interjecting more misdirection and contradictions. For example, appellants contend that WBBM's 2001 Wage and Withholding reports and 2000, 2001, and 2002 California tax returns (Form 100S) reflecting salaries and wages paid to employees other than appellant-husband substantiate their assertion that appellant-husband was not the sole employee of WBBM. In contrast, annual valuation statements and employee census forms by American Qualified Plans (AQP) for each of the taxable years at issue state the opposite. Moreover, one of appellants' witnesses (Vicki) declared that in January 1999, she and 25 other WBB employees transferred to WBBM. However, the W-2 issued to Vicki for 1999 continued to reflect WBB, not WBBM as her employer during the year. Additionally, WBBM's 1999 California tax return (Form 100S) reported that WBBM had $960,000 in income (all from the employee leasing contract with WBB) and $297,717 in expenses; the return did not report any salaries and wages paid to employees during 1999 other than the $275,000 paid to appellant-husband. The remaining expense deductions were for taxes and licenses ($9,289), ESOP contributions ($13,000), and for "other deductions" ($428). Vicki submitted her 1999 W-2[2] reflecting wages of over $50,000 which, along with the salaries of the other twenty-five employees who transferred to WBBM with her, are not reflected on WBBM's 1999 tax return. Clearly, the math does not work because the salaries of the claimed WBB transferees were not

[2] As another example of the many contradictions in appellants' arguments, Vicki's W-2 named WBB, not WBBM, as her employer.

included in the computation of WBBM's 1999 income, and, thus, appellants' arguments simply do not add up. Even if WBBM had other employees during some of the taxable years at issue, the essential point is that appellant-husband was the only ESOP participant during the taxable years at issue, and all of the outstanding WBBM stock was allocated to his ESOP account.

Unfortunately, appellants continue along this vein in the PFR itself. The PFR claims that the Opinion found appellant-husband to be an employee of WBB. We find no such determination in our ruling and, even if there is some manner where it can be so interpreted, such a finding does not alter the fact that appellants were engaged in an ATAT. Furthermore, instead of explaining why their post-hearing brief understated the vested accrued benefit of appellant-husband's WBBM ESOP, appellants opted to improperly[3] argue that OTA violated the Evidence Code; this suggests that appellants were less than forthright when OTA asked them for specific data that would impact their tax liability. With respect to the Reliance Surety email exchange, Mr. Gaidano's testimony under cross-examination verified that the writers were referring to appellants and that Mr. Gaidano was the CPA referred to in said emails.

Reciting one sentence from the Opinion, appellants assert that the proper taxpayer was WBB, not appellants and that they were wrongfully assigned the additional income. Unfortunately, appellants failed to read the rest of that paragraph wherein we recognized the Court's decision in *Moline Properties*,[4] and questioned FTB's approach in allocating all of WBBM's income to appellants. At the end of the day, the Opinion determined that the approach taken by the IRS in these types of cases, as described in Exhibit BB, was the more reasonable methodology and applied it by allocating income to appellants to the extent of appellant-husband's vested accrued benefit in his ESOP account.

Finally, with their PFR, appellants attempt to re-argue issues that were resolved in the Opinion. Thus, there is no need for us to revisit the timeliness of FTB's notices (along with the related burden of proof/listed transaction question), the inadequacies of appellants' disclosures for purposes of reducing the NEST penalty, and the applicability of the IB penalty (as the

[3] FTB correctly points out that section 1152 of the Evidence Code does not apply to OTA. (See Cal. Code Regs., tit. 18, § 30214(e).) Moreover, the closing agreements basically implement the process announced in 1999 by the IRS in its publication regarding the handling of management S corporation ESOP structures (Exh. BB); because Exhibit BB was a public pronouncement, it is hardly confidential, and if appellants post-hearing brief had not understated appellant-husband's vested accrued benefit in his ESOP account, we would have arrived at the same conclusion without the closing agreements.

[4] *Moline Properties, Inc. v. Comm'r* (1943) 319 U.S. 436.

Opinion already discussed the level of appellant-husband's knowledge of the ESOP, as well as AQP's contractual protection).[5]

Therefore, we believe that the Opinion was supported by the record and not contrary to law. Hence, we find appellants' PFR unpersuasive and appellants' PFR is denied.

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Tommy Leung
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Tommy Leung
Administrative Law Judge

We concur:

DocuSigned by:
Cheryl Akin
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Cheryl Akin
Administrative Law Judge

DocuSigned by:
John O Johnson
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John O. Johnson
Administrative Law Judge

Date Issued: 5/13/2020

[5] Appellants also appear to make a policy argument regarding the contractual protection requirement with respect to other transactions, such as mergers and acquisitions; these points assume facts that are not in the record and, while interesting, are better left for the Legislature to resolve.