OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeals of:	) OTA Case No. 18042698
ESTATE OF TONY D. STELLIGA	)
	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Desmond Stelliga
For Respondent:	Brandon S. Knoll, Tax Counsel
For Office of Tax Appeals:	Linda Frenklak, Tax Counsel IV

P. KUSIAK, Administrative Law Judge: Pursuant to California Revenue and Taxation Code (R&TC) section 19045, the Estate of Tony D. Stelliga (appellant)[1] appeals an action by respondent Franchise Tax Board (FTB) proposing an assessment for the 2007 tax year of additional tax of $229,927 and imposing a noneconomic substance transaction (NEST) penalty of $86,174 and an interest-based penalty of $58,523.37, plus applicable interest.

Appellant waived his right to an oral hearing and requested that this matter be decided based on the written record.

[1] The appeal record contains documents that refer to the decedent as D. Tony Stelliga or Tony D. Stelliga. The appeal letter uses the latter name. For the sake of consistency, this decision will refer to the decedent as Tony D. Stelliga or appellant. The proposed assessments of additional tax and penalties in this case were issued to appellant in 2013. The protest leading to this appeal was filed by Tony D. Stelliga. During the pendency of the protest, Tony D. Stelliga died and this appeal was filed by a representative of the estate of Tony D. Stelliga.

ISSUES

1. Whether appellant has shown that FTB improperly determined that his reported sale of his income interest in the Tony D. Stelliga Charitable Remainder Unitrust (Trust) to the Regents of the University of California (UC Regents) should be disregarded for tax purposes because it lacked economic substance.
2. Whether appellant had taxable gain in the amount of $2,199,094 in 2007 on the disposition of appellant's income interest in the Trust.
3. Whether appellant was entitled to claim a charitable deduction for the $150,000 received by the UC Regents.
4. Whether a NEST penalty under R&TC section 19774 was properly imposed.
5. Whether an interest-based penalty under R&TC section 19777 was properly imposed.

FACTUAL FINDINGS

A. Background

1. On July 6, 1999, appellant and his wife, Lori F. Stelliga, created the Stelfam 1999 Charitable Remainder Unitrust (CRUT) for a term of 20 years and contributed 1,188,600 shares of Softcom Microsystems, Inc. common stock, described as founders' stock.[2] Appellant's basis in the stock was zero. The Stelfam 1999 CRUT's Trust Agreement provided that, at the expiration of the trust term, the trustee shall distribute the trust to the charitable remainder beneficiaries listed in Schedule B. Appellant and his wife were settlors, income beneficiaries, and the initial trustees of the Stelfam 1999 CRUT. After the spouses resigned as co-trustees, Adam Gensler became the sole trustee of the Stelfam 1999 CRUT. During the term of the Stelfam 1999 CRUT, the shares of Softcom Microsystems, Inc. stock were sold and the proceeds from the stock sales were reinvested.
2. Appellant and his wife separated in 2005. By court order, the Stelfam 1999 CRUT was terminated and its property was equally divided and transferred to two separate CRUTs: 1) the Tony D. Stelliga Charitable Remainder Unitrust (hereinafter referred to as the Trust); and 2) the Lori F. Stelliga Charitable Remainder Unitrust (hereinafter referred to as the Lori F. Stelliga CRUT). Appellant became the primary income beneficiary of the

[2] Founders' stock is a term used to describe the shares that a company issues to its early equity participants.

Trust, with Ms. Stelliga as a contingent income beneficiary. Ms. Stelliga became the income beneficiary of the Lori F. Stelliga CRUT. Adam Gensler was the Trust's trustee and the Trust was set to terminate 20 years from June 30, 1999.

3. The Trust Agreement provided that the income amount payable each year was equal to the lesser of the trust income for the year or 11.343 percent of the net fair market value of the trust assets determined on the first business day of the year. The Trust Agreement contained a net income make-up provision that allowed an additional payment in any year when the Trust's net income exceeded 11.343 percent of the fair market value of the trust assets; the additional payment would only be allowed when the aggregate of the net income paid in prior years was less than the aggregate of 11.343 percent of the fair market value of the Trust's assets for those prior years. The Trust Agreement provided that at the expiration of the Trust's term, the trustee would distribute the assets to the charitable remainder beneficiaries listed in Schedule B to the Trust Agreement.

4. On or about June 26, 2007, an agreement for the joint sale of beneficial interests in the Trust, termination of the Trust, and distribution of the assets of the Trust (Agreement) was executed by 1) appellant, as the Trust's primary income interest holder; 2) Lori F. Stelliga, as the Trust's contingent income interest holder; 3) the Robert Packard Center for ALS Research at Johns Hopkins University (hereinafter referred to as Johns Hopkins), as the Trust's remainder interest holder;[3] 4) Mr. Gensler, as the Trust's trustee; and 5) Geoffrey A. O'Neill, as counsel for the UC Regents. The Agreement provides that the Trust's income (primary and contingent) interest holders and remainder interest holder agreed to jointly sell, and the UC Regents agreed to purchase, their respective interests in the Trust at a purchase price equal to the aggregate value of the Trust's assets as of the closing date, minus any liabilities of the Trust as of the closing date, and minus $150,000. The Agreement asserts that the Trust's property's fair market value was estimated to be approximately $2.7 million. The Agreement states that the Trust's property would "consist solely of cash or cash equivalents the fair market value of which would be not less than the sum of the Purchase Price, plus $150,000." The Agreement also stated that the purchase price would be paid by the purchaser in cash, cashier's

[3] It is unclear from the appeal record when Johns Hopkins became the Trust's designated remainder interest holder.

check, money order, wire or similar transfer not later than thirty (30) days from the closing date. The Agreement provides that the purchase price would be allocated as follows: 1) Johns Hopkins, as the Trust's remainder interest holder, would receive 24.879 percent of the aggregate value of the Trust's assets; 2) Lori F. Stelliga, as the contingent income interest holder, would receive 0.9235 percent of the aggregate value of the Trust's assets; and 3) appellant, as the present income interest holder, would receive 74.1975 percent of the aggregate value of the Trust's assets less $150,000. The Agreement also required the present income interest holder to pay 98.78%, and the contingent income interest holder to pay 1.22%, of all costs and expenses incurred by the Purchaser in connection with the negotiation, execution, and performance of the Agreement, not to exceed $1,000. The Agreement acknowledged appellant's intent to support acquisition of lab equipment by the Department of Electrical Engineering and Computer Science in the College of Engineering at the University of California with the $150,000 set aside from the purchase price. The Agreement also provided that, upon acquisition of the present income interest, the contingent income interest, and the remainder interest, the UC Regents will own Trust interests that constitute all of the beneficial interests in the Trust, and the Trust will, thereupon, terminate in accordance with section 15407(a)(2) of the California Probate Code.

5. In correspondence dated July 19, 2007, Sid Luckenbach of Wealth and Tax Advisory Services, Inc. provided a valuation analysis related to the income and remainder interests in the Trust as of the valuation date of June 30, 2007. The value of the income interest was determined to be $2,226,465 by subtracting the remainder interest value of $737,373 from the total value of the Trust's net assets of $2,963,838. The letter noted that, based on the allocation of the income interest set forth in the Agreement, Lori F. Stelliga, as the contingent income interest holder, would be entitled to approximately $27,371 and appellant, as the primary income interest holder, would be entitled to $2,199,094.

6. In correspondence to Schwab Institutional (Charles Schwab) dated July 19, 2007, Mr. Gensler, as trustee of the Trust, indicated that all of the beneficiaries of the Trust executed a joint sale agreement with the UC Regents. Charles Schwab was instructed to transfer on July 20, 2007, the entire balance of the Trust's account to a specific University of California account that was also held at Charles Schwab.

7. In correspondence dated July 20, 2007, Charles Schwab confirmed a transfer of $548,418.20 of cash and cash equivalents with a market value of $2,415,419.60 to an account belonging to the Office of the Treasurer for the University of California.
8. In correspondence dated September 17, 2008, UC Regents acknowledged receipt of the July 27, 2007 gift of $150,000, which would be directed to the Department of Electrical Engineering and Computer Science in the College of Engineering at UC Berkeley. The letter also stated appellant received no goods or services in return for his donation.

B. Tax Returns

9. On October 3, 2008, appellant filed 2007 California and federal income tax returns (FTB Form 540, IRS Form 1040), using the married filing separately filing status. On his 2007 California income tax return, appellant reported wages of $259,770 and federal and California adjusted gross income (AGI) of $253,648. After subtracting itemized deductions of $120,930, he reported taxable income of $132,718 and a total tax of $10,148. After subtracting income tax withholdings of $19,198, he claimed a refund of $9,050. On Schedule A of his 2007 federal income tax return, appellant reported federal itemized deductions of $531,019, including a gift to charity of $150,000, which was reduced to $126,824 with a carryover of $23,176. On Schedule D of his 2007 federal income tax return, appellant reported a long-term capital gain of zero from the sale of a CRUT interest on July 27, 2007, for a sale price of $2,049,094 and a cost or other basis of $2,049,094. On IRS Form 8283, which was attached to appellant's 2007 federal return, appellant reported a donation of an annuity interest in a CRUT with an appraised fair market value of $2,199,094 to the University of California on July 27, 2007, a donor's cost or adjusted basis of $2,199,094, a bargain sale of $2,049,094, and a claimed deduction of $150,000.

C. Federal "Transaction of Interest"

10. On October 31, 2008, Treasury and Internal Revenue Service (IRS) issued Notice 2008-99, identifying as a "transaction of interest" a type of transaction in which a sale or other disposition of all interests in a CRUT (subsequent to contribution of appreciated assets to and their reinvestment by the CRUT) results in the grantor or other noncharitable

recipient receiving the value of that person's CRUT interest while claiming to recognize little or no taxable gain.

The Notice described the transaction as follows: Grantor creates a CRUT and contributes appreciated assets (Appreciated Assets) to the CRUT. Grantor retains an annuity or unitrust interest. Next, the CRUT sells or liquidates the Appreciated Assets and reinvests the proceeds in other assets (New Assets). Because a CRUT is a tax-exempt entity under IRC section 664, the CRUT's sale of Appreciated Assets is exempt from income tax, and the CRUT's basis in the New Assets is the price the CRUT paid for the New Assets. Next, the Grantor and the Charity, in a transaction they claim is described in IRC section 1001(e)(3), sell or otherwise dispose of their respective interests in the CRUT to an unrelated third party, for an amount that approximates the fair market value of the CRUT, including the New Assets. Then the CRUT terminates, and the assets of the CRUT, including the New Assets, are distributed to the unrelated third party.

When the Grantor and charity sell their respective interests in the CRUT to an unrelated third party, Grantor and the Charity take the position that they have sold the entire interest in the CRUT, within the meaning of IRC section 1001(e)(3). Because the entire interest in the CRUT is sold, Grantor claims that IRC section 1001(e)(1), which disregards basis in the case of a term interest, does not apply to the transaction. Grantor also takes the position that, under IRC section 1001(a) and related provisions, the gain on the sale of the Grantor's term interest is computed by talking into account the portion of the uniform basis allocable to the Grantor's term interest under Treasury Regulation sections 1.1014-5 and 1.1015-1(b), and that this uniform basis is derived from the basis of the New Assets rather than the basis of the Appreciated Assets contributed to the CRUT.

The Notice identifies the transaction and substantially similar transactions as "transactions of interest" for purposes of Treasury Regulation section 1.6011-4(b)(6) and Internal Revenue Code (IRC) sections 6111 and 6112. Persons entering into these transactions on or after November 2, 2006, must disclose the transaction as described in Treasury Regulation section 1.6011-4. There is no indication in the record that the required disclosure form (Form 8886) was filed with respect to the sale or disposition of appellant's interest in the Trust.[4]

D. Audit

11. On April 26, 2011, FTB initiated an audit of appellant's 2007 return. During the audit, appellant and FTB executed waivers that extended the statute of limitations for FTB to propose a deficiency assessment to October 3, 2013.

12. In the Audit Issue Presentation Sheet (AIPS) dated March 12, 2013, the auditor noted that appellant's 2007 return reported a zero gain from the sale of his term income interest in the Trust to the UC Regents based on a sales price of $2,049,094 and a cost or other basis of $2,199,094 and claimed a charitable donation of $150,000. In the AIPS, the auditor determined that:

a) Abusive Tax Avoidance Transaction (ATAT). Appellant's reported sale of his term income interest in the Trust to the UC Regents for zero gain should be disregarded for tax purposes because it was an ATAT that lacked both economic substance and a business purpose and constituted a sham transaction.

a. Taxable Gain. The correct amount of taxable gain that appellant realized from the disposition of appellant's income interest in the Trust was $2,199,094.

b. Charitable Deduction. The claimed charitable deduction for appellant's contribution of $150,000 to the UC Regents should be disallowed.

c. NEST Penalty. The NEST penalty based on 40 percent of the noneconomic substance transaction understatement of tax should be imposed pursuant to R&TC section 19774, because tax avoidance was the only anticipated economic benefit from the sale of the Trust's assets to the UC Regents.

d. Interest-Based Penalty. The interest-based penalty, which amounts to 100 percent of the interest calculated from the original due date of the return to the date when a

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[4] After studying this type of transaction and receiving comments from the public, Treasury and IRS issued a notice of proposed rulemaking relating to basis in interests in tax-exempt trusts. Subsequently, Treasury amended Treasury Regulation section 1.1014-5, Gain or Loss, by adding subsection (c), sale or other disposition of a term interest in a tax-exempt trust. In the case of a sale or other disposition of a term interest in a tax-exempt trust to which IRC section 1001(e)(3) applies, the new provision reduces basis of a term interest in the tax-exempt trust by the trust's undistributed net ordinary income and the trust's undistributed net capital gains. (See T.D. 9729.) Treasury Regulation section 1.1014-5(c) applies to sales or other dispositions of interests in CRTs occurring on or after January 16, 2014, and are not applicable to the sale or disposition of appellant's term interest in the Trust that is the subject of this appeal.

Notice of Proposed Assessment (NPA) would be mailed, should be imposed pursuant to R&TC section 19777, because FTB contacted appellant regarding an ATAT and appellant has a deficiency attributable to an ATAT, which, in this case, includes a transaction to which the NEST penalty under R&TC section 19774 applies.

e. Interest Suspension. Interest should not be suspended under R&TC section 19116 because the purported sale falls within the definition of an ATAT.

13. FTB issued to appellant an NPA for 2007 dated July 2, 2013, increasing appellant's reported taxable income by $2,316,508 (from $132,718 to $2,449,226), consisting of a CRUT term interest basis adjustment of $2,049,094, additional realized gain of $150,000, and a revised disallowed charitable deduction of $117,414.[5] The NPA proposed additional tax of $229,927, including a mental health tax of $14,492, and imposed a NEST penalty of $86,174 and an interest-based penalty of $58,523.37, plus interest. The NPA stated that interest was not suspended, because the transaction at issue falls within the definition of an ATAT, and if the NEST penalty was not sustained, then FTB reserved the right to impose an accuracy-related penalty pursuant to R&TC section 19164.

E. Protest

15. Appellant protested the NPA in a letter dated August 28, 2013.[6]

16. FTB affirmed the NPA in a Notice of Action (NOA) dated November 21, 2017. Appellant then filed this timely appeal.

DISCUSSION

Issue 1: Whether appellant has shown that FTB improperly determined that his reported sale of his income interest in the Tony D. Stelliga Charitable Remainder Unitrust (Trust) to the Regents of the University of California (UC Regents) should be disregarded for tax purposes because it lacked economic substance.

A CRUT is a trust that is formed to make current distributions to its noncharitable income beneficiaries and to pay the remainder interest to a charity or to use it for a charitable purpose.

[5] FTB does not discuss in the NPA or its brief why it reduced the revised disallowed charitable deduction to $117,414 after the auditor reduced it from the claimed amount of $126,824 to $120,930, as reflected in the AIPS.

[6] A copy of the August 28, 2013 protest letter is not in the appeal file.

(IRC, § 664(d)(2); Treas. Reg. § 1.664-1.)[7] Any amounts that a CRUT distributes to its beneficiaries prior to its termination is considered to have the following characteristics in the hands of the beneficiaries: 1) first as ordinary income to the extent of such income of the trust for the year and such undistributed income of the trust for prior years; 2) second as capital gain to the extent of the capital gain of the trust for the year and the undistributed capital gain of the trust for prior years; 3) third as other income to the extent of such income of the trust for the year and such undistributed income of the trust for prior years; and 4) fourth as trust corpus. (IRC, § 664(b).) A CRUT is not subject to income tax. (IRC, § 664(c)(1).) Money and property that the beneficiary receives after the termination of the CRUT, however, are not governed by IRC section 664 because they are not distributions of an annual unitrust amount. Instead, the beneficiary is disposing of his or her income interest in the CRUT in a transaction subject to IRC section 1001.

The *pro rata* division of a CRUT into two or more separate CRUTs does not cause the original CRUT or any of the resulting CRUTs to fail to qualify as a CRUT under IRC section 664(d). (See Rev. Rul. 2008-41.) When a trust that qualifies as a CRUT under IRC section 664(d) is divided *pro rata* into two or more separate CRUTs, the basis under IRC section 1015 of each separate CRUT's share of each asset is the same share of the basis of that asset in the hands of the original CRUT immediately before the division of the original CRUT. (Treas. Reg. § 1.1015-2(a)(1); Rev. Rul. 2008-41.)

IRC section 61(a)(3) includes gains derived from dealings in property in its definition of gross income.[8] IRC section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized over the adjusted basis provided in IRC section 1011 for determining gain.[9] IRC section 1001(b) defines "amount realized" from the sale of property as "the sum of any money received plus the fair market value of the property (other than money) received." IRC section 1001(c) states, "Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized."

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[7] California conforms to IRC section 664 at R&TC section 17731; R&TC section 17755 provides, however, that California does not conform to IRC section 664(c)(2) relating to excise tax, which is not relevant to this appeal.

[8] California conforms to IRC section 61 at R&TC section 17071.

[9] California conforms to IRC sections 1001 and 1011-1016 at R&TC section 18031.

IRC section 1011(a) provides that the adjusted basis for determining gain from the sale or other disposition of property, whenever acquired, shall be the property's cost basis adjusted as provided in IRC section 1016.

IRC section 1001(e)(1) provides that when determining gain or loss from a beneficiary's sale or other disposition of a term interest in property the portion of the adjusted basis of such interest that is determined pursuant to IRC section 1014, 1015, or 1041 shall be disregarded. (See Treas. Reg. §§ 1.1001-1(f)(1), 1.1014-5(b)(1).) A term interest in property is defined to include an income interest in a trust. (IRC, § 1001(e)(2)(C).) IRC section 1001(e)(3) states, however, that the general rule set forth in IRC section 1001(e)(1) does not apply to a sale or other disposition which is a part of a transaction in which the entire interest in property is transferred to any person or persons. (See Treas. Reg. § 1.1001-1(f)(3).)

Pursuant to IRC section 1001(e)(1), the portion of the adjusted uniform basis assigned to the life income beneficiaries' interests in the Trust is disregarded. Accordingly, the life income beneficiaries have no basis in their interests in the Trust. Therefore, the amount of gain the life beneficiaries must recognize under IRC section 1001(c) is the amount they realize from the disposition of their interests in the Trust. The gain realized by the life income beneficiaries from the disposition of their interests in the Trust will be long-term capital gain where, as here, the interest, a capital asset pursuant to IRC section 1221, was held for a period in excess of one year (IRC, § 1222(3)).

If, however, the entire interest in the Trust's assets is sold, or otherwise disposed of in a single transaction to a third party, the exception contained in IRC section 1001(e)(3) (to disregard the rule of IRC section 1001(e)(1)) is applicable. This appears to have been the appellant's position on protest. But on appeal appellant has not asserted that position – or any other position to rebut the position of FTB.

FTB's determinations as to issues of fact are presumed correct and the taxpayer bears the burden of proving such determinations erroneous. (*Appeal of Seltzer* (80-SBE-154) 1980 WL 5068.) To rebut this presumption, a taxpayer must produce credible, competent, and relevant evidence concerning the issues in dispute. (*Id*.) A taxpayer's unsupported assertions are not sufficient to satisfy his or her burden of proof. (*Appeal of Walshe* (75-SBE-073) 1975 WL 3557.) Here FTB asserts the transaction involving a purported sale of Trust interests to UC

Regents is a sham transaction without economic substance that should be ignored for income tax purposes.

Economic Substance Doctrine

The economic substance doctrine has been articulated by courts as a means of disregarding transactions for tax purposes that may comply with the language of the IRC but lack true economic substance. The United States Supreme Court stated that the relevant inquiry is whether "there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached[.]" (*Frank Lyon Co. v. United States* (1978) 435 U.S. 561, 583-84.)

In determining whether a transaction is a sham that lacks economic substance, the Ninth Circuit Court of Appeals applies the following two-pronged test: (1) whether the taxpayer has demonstrated a non-tax business purpose for the transaction (a subjective analysis); and (2) whether the taxpayer has shown that the transaction had economic substance beyond the creation of tax benefits (an objective analysis). (*Casebeer v. Comm'r* (9th Cir. 1990) 909 F.2d 1360, 1362-1363; see also *Appeal of Alyn* (2009-SBE-001) 2009 WL 2340393.) The Ninth Circuit has held that this test is not a "rigid two-step analysis," but instead a single inquiry into whether the transaction had any practical economic effects other than tax benefits. (*Reddam v. Comm'r* (9th Cir. 2014) 755 F.3d 1051, 1060; see also *Slone v. Comm'r* (9th Cir. 2015) 810 F.3d 599, 606; *Casebeer v. Comm'r, supra*, 909 F.2d at p. 1363.) "The ultimate determination of whether a transaction lacks economic substance is a question of fact." (*Hunter v. Comm'r*, T.C. Memo. 2014-132 (citing *Sochin v. Comm'r* (9th Cir. 1988) 843 F.2d 351, 353).)

Applying the two-prong economic substance test, we examine the entire transaction to determine whether the interest holder's purported sale of his interest in the Trust had any practical economic effects other than tax benefits. Specifically, we address whether appellant has established the following: (1) a subjective business purpose for selling the interest in the Trust to the UC Regents; and (2) an objective economic substance for the sale of the interest in Trust to the UC Regents.

Subjective Business Purpose Factor

The business purpose factor involves an examination of the subjective factors that motivated the taxpayer to engage in the transaction at issue. (*Casebeer v. Comm'r, supra*, 909 F.2d at pp. 1363-1364.) The business purpose analysis considers whether there were business purposes other than avoiding tax. (*Id*. at p. 1363.)

At protest and on appeal, appellant has not established any subjective business purpose for the sale of the interest in the Trust to the UC Regents. Assuming that appellant's non-tax benefit business purpose in selling his income interest in the Trust to the UC Regents was to obtain a reservoir of cash to pay debts or to gain investment opportunities, this transaction was clearly unnecessary and convoluted. The interest holders would have been able to terminate the Trust and receive their *pro rata* allocation of the proceeds from the sale of the Trust's net assets without transferring money back and forth with a third party. Because appellant has not articulated or substantiated a business purpose for engaging in the sale of the interest in the Trust to the UC Regents other than tax avoidance, we conclude that he has not satisfied the subjective business purpose factor.

Objective Economic Substance Factor

The economic substance factor looks at whether the substance of a transaction reflects its form and involves an examination of whether the transaction was objectively capable of creating a profit or affecting the taxpayer's financial situation. (*Casebeer v. Comm'r, supra*, 909 F.2d at p. 1365.) "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." (*Comm'r v. Court Holding Co.* (1945) 324 U.S. 331, 334.)

Based on the terms of the Agreement, the Trust transferred cash or cash equivalents to the UC Regents for a holding period of 30 days for which the UC Regents received $150,000, funded indirectly by appellant, by paying $150,000 less than $2.9 million for $2.9 million in cash and cash equivalents. To satisfy the Agreement's requirement that "the purchase price" be reduced to cash or cash equivalents, the Trust would have to liquidate the Trust's noncash assets prior to the closing date. The Agreement provides that 100 percent of the purchase price would be paid on a *pro rata* basis to appellant, Ms. Stelliga, and Johns Hopkins, as the sellers in interests in the Trust, in exchange for transferring to the UC Regents, as the buyer, the sum of

$2,963,838, which was the aggregate value of the Trust's assets, minus $150,000. According to the Agreement, the payment of $150,000 to the UC Regents was funded by reducing the appellant's *pro rata* share of the purchase price. At the end of the 30-day holding period, the UC Regents, as the buyer, gained nothing expressly from this transaction other than $150,000.

There is no evidence in the appeal record that substantiates that the UC Regents, as the buyer, paid the Trust's interest holders, as the sellers, any consideration for its purported purchase of the interests in the Trust. The only reasonable motive on the part of the UC Regents for engaging in this transaction was to earn a profit on the investment of $2,963,838 that it received and held during the 30-day holding period and to receive $150,000 from appellant for participating in the transaction. In turn, the only reasonable motive on the part of appellant for engaging in this transaction was to create the fiction of a sale of the entire interest in the Trust to avoid paying income tax on any portion of the gain realized from the liquidation of his *pro rata* share of the Trust's assets prior to the transfer of funds to the UC Regents, as indicated by appellant's 2007 return, which reports zero realized gain. Appellant has not substantiated that the sale was objectively capable of creating a profit or otherwise affecting appellant's financial situation. He thus failed to satisfy the objective economic substance factor. Because the sale to the UC Regents lacked both a business purpose and economic substance, we conclude that FTB properly disregarded this transaction for income tax purposes.

<u>Issue 2: Whether appellant has shown that FTB improperly determined that the amount of gain realized from the early termination of the Trust was $2,199,094</u>.

FTB has the initial burden of showing that its proposed assessment is reasonable and rational. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Myers* (2001-SBE-001) 2001 WL 37126924.) Once this burden is met, FTB's determination is presumed correct and appellant has the burden of proving it to be wrong. (*Todd v. McColgan*, *supra*; *Appeal of Byrd* (84-SBE-167) 1984 WL 16246.) A taxpayer's unsupported assertions are insufficient to carry this burden of proof. (*Appeal of Magidow* (82-SBE-274) 1982 WL 11930; *Appeal of Manriquez* (79-SBE-77) 1979 WL 4118.) A taxpayer'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 Cookston* (83-SBE-048) 1983 WL 15434.)

The Stelfam 1999 CRUT would not have recognized any gain or loss from the sale of its shares of Softcom Microsystems, Inc. stock, because a CRUT is not subject to tax. (IRC,

§ 664(c)(1).) In contrast, appellant's receipt of $2,199,094, his share of the proceeds from the liquidation of the Trust's assets upon the termination of the Trust, was not subject to the nonrecognition rule of IRC section 664(c)(1). The determination of the amount of appellant's gain or loss realized from this transaction is therefore governed by IRC section 1001.

The July 19, 2007 valuation analysis letter's statement that, upon the termination of the Trust, appellant, as the primary income interest holder, would be entitled to receive $2,199,094, is persuasive evidence of the fair market value of appellant's income interest in the Trust at the time that the Trust was terminated in 2007. Consistent with the July 19, 2007 valuation analysis letter, appellant reported on his 2007 IRS Form 8283 that his income interest had a fair market value of $2,199,094 on July 27, 2007, which he reduced by $150,000, resulting in a bargain sale of $2,049,094 and a claimed deduction of $150,000.[10] (See IRC, § 1011(b).) On Schedule D of his 2007 federal return, however, appellant reported that he had a realized gain of zero from the sale of his income interest in the Trust on July 27, 2007, with a sale price of $2,049,094 and a cost or other basis of $2,049,094.

Appellant and Ms. Stelliga were the settlors of the Stelfam 1999 CRUT who gave themselves their income interests in the Stelfam 1999 CRUT on July 6, 1999, the date when they established this CRUT and contributed 1,188,600 shares of Softcom Microsystems, Inc. stock to it. As conceded by appellant, the couple's basis in these assets, described as founder's stock, was zero. In April 2006, the Stelfam 1999 CRUT was terminated and its assets were divided equally and contributed to the Trust and the Lori F. Stelliga CRUT pursuant to a court order. Accordingly, the amount that appellant realized from the disposition of his term income interest upon the early termination of the Trust is the amount of recognized gain on his *pro rata* portion of the Trust's assets, which is not reduced by any basis. There is no evidence in the appeal record that substantiates that when the Trust was terminated in 2007 appellant's term income interest had a basis other than zero.

Since appellant acquired his term income interest in the Trust by a transfer in trust, as described in IRC section 1015(b), IRC section 1001(e)(1) would apply to determine gain or loss on the sale or other disposition of a term interest in property, unless the exception in IRC section 1001(e)(3) applies.

[10] "A bargain purchase is a purchase of an item for less than its fair market value." (IRS Publication 551 (Dec. 2018), p. 7.)

Appellant had ample opportunities at audit and protest, as well as during this appeal, to substantiate the basis of the assets in the hands of the Trust and the Stelfam 1999 CRUT. In the appeal letter, appellant merely stated that he was appealing the NOA and that he "reserve[d] the right to supplement his appeal letter with additional facts and circumstances." The Office of Tax Appeals (OTA) accepted this appeal based on this succinct appeal letter and provided appellant an opportunity to supplement his appeal letter but he declined to do so. After FTB filed its brief, OTA provided appellant an opportunity to file a reply brief but he declined to do so. Appellant has failed to establish that he properly reported on his 2007 return that his income interest in the Trust had a cost or other basis of either $2,049,094 or $2,199,094. We conclude that FTB properly determined that at the time that the Trust was terminated in 2007, appellant had a realized gain of $2,199,094 based on his interest income in the Trust having an appraised fair market value of $2,199,094 and a zero basis.

<u>Issue 3: Whether appellant is entitled to claim a charitable deduction for the $150,000 received by the UC Regents</u>.

Taxpayers bear the burden of proving their right to a claimed deduction. (*INDOPCO, Inc. v. Comm'r* (1992) 503 U.S. 79.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Magidow*, *supra*.)

IRC section 170(a)(1) allows a deduction for any charitable contribution that is made during the tax year.[11] IRC section 170(c)(2) defines a "charitable contribution" for this purpose to include a contribution or gift to or for the use of a state if the contribution or gift is made for exclusively public purposes. Generally, the deduction amount is the value of the contributed property, reduced by the value of any consideration that the taxpayer receives in exchange for the donation. (*Addis v. Comm'r* (2002) 118 T.C. 528, 536, affd. (9th Cir. 2004) 374 F.3d 881.) Pursuant to IRC section 170(f)(8), charitable organizations that receive quid pro quo contributions, i.e., payments made partly as a contribution and partly in consideration for goods or services provided to the donor by the donee organization, are required to inform their donors that the deduction under IRC section 170 is limited to the amount by which the payment exceeds the value of goods or services provided by the charity. In addition, "[IRC] Section 170(f)(8)(A) provides: 'No deduction shall be allowed * * * for any contribution of $250 or more unless the

[11] California conforms to IRC section 170 at R&TC section

taxpayer substantiates the contribution by a contemporaneous written acknowledgment of the contribution by the donee organization that meets the requirements of subparagraph (B).'" (*Big River Dev., L.P. v. Comm'r*, T.C. Memo. 2017-166.)

"[A] taxpayer's desire to avoid or eliminate taxes by contributing cash or property to charities cannot be used as a basis for disallowing the deduction for that charitable contribution." (*Skripak v. Comm'r* (1985) 84 T.C. 285, 319, citations omitted.) See also *Scheidelman v. Comm'r* (2d Cir. 2012) 682 F.3d 189, 200; *Weitz v. Comm'r*, T.C. Memo. 1989-99; *Hunter v. Comm'r*, T.C. Memo. 1986-308.) Treasury Regulation section 1.170A-1(e) provides, however, that if, as of the date of a gift, a transfer of property for charitable purposes is dependent on the performance of some act or the happening of a precedent event in order for it to become effective, no charitable deduction is allowable under IRC section 170, unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. Furthermore, the economic substance doctrine is applicable and relevant to the determination of whether a taxpayer's contribution to a charitable organization is deductible under IRC section 170. (*Zavadil v. Comm'r* (8th Cir. 2015) 793 F.3d 866, 869-870; *Skripak v. Comm'r, supra*, 84 T.C. 285, 315 [the various documents in fact comport with the economic substance and reality of these transactions]; *Mount Mercy Assocs. v. Comm'r*, T.C. Memo. 1994-83, affd. sub nom. *Mt. Mercy Assoc. v. Comm'r* (2d Cir. 1995) 50 F.3d 2; *Weitz v. Comm'r, supra*; see also IRS Chief Counsel Advice 201507018 (Feb. 13, 2015).)[12]

The Ninth Circuit Court of Appeals applies a quid pro quo analysis to determine whether a charitable benefit was provided under IRC section 170.

> If a transaction is structured in the form of a quid pro quo, where it is understood that the taxpayer's money will not pass to the charitable organization unless the taxpayer receives a specific benefit in return, and where the taxpayer cannot receive the benefit unless he pays the required price, then the transaction does not qualify for the deduction under [IRC] section 170.

(*Graham v. Comm'r* (9th Cir. 1987) 822 F.2d 844, 849, affd. sub nom., *Hernandez v. Comm'r* (1989) 490 U.S. 680; see also *Scheidelman v. Comm'r* (2d Cir. 2012) 682 F.3d 189, 199 ["Courts have implemented this *quid pro quo* principle by looking to 'the external features of the transaction in question' …."].) Accordingly, the Ninth Circuit Court of Appeals has held that

[12] IRS Chief Counsel Advice 201507018 (Feb. 13, 2015) may be found on the IRS website at: <www.irs.gov/pub/irs-wd/201507018.pdf>.

"tuition payments to parochial schools, which are made with the expectation of a substantial benefit, or quid pro quo, 'have long been held not to be charitable contributions under [IRC section] 170.'" (*Skylar v. Comm'r* (9th Cir. 2008) 549 F.3d 1252, 1259 (quoting *Hernandez v. Comm'r*, *supra*, 490 U.S. at p. 693); see also *DeJong v. Comm'r* (9th Cir. 1962) 309 F.2d 373, 376 ["The law is well settled that tuition paid for the education of the children of a taxpayer is a family expense, not a charitable contribution to the educating institution."].)

In this case, there was no payment by appellant to UC Regents of $150,000. Instead, UC Regents received the $150,000 in question by engaging in a purported purchase agreement where UC Regents paid $2,813,831.80 to the owners of all the interests in the Trust, consisting of cash and cash equivalents worth $2,963,831.90. By the terms of the agreement, the purchase price was required to be $150,000 less than the value of the cash and cash equivalents that were purchased. But for the transaction, UC Regents would not have received anything. In addition, pursuant to the Agreement, any costs or expenses of UC Regents, not to exceed $1,000, were paid by the present and contingent income interest holders.

And what did the appellant receive? If the transaction was respected as a valid sale of an entire interest in the Trust and not disregarded as discussed under Issue 1 above, the appellant would have avoided California personal income tax of $229,927 and mental health tax of $14,492, as reflected in the NPA.[13]

Applying the Ninth Circuit's quid pro quo analysis to the evidence in the appeal record, we conclude that appellant expected to gain a substantial tax benefit from the transaction where $150,000 was received by the UC Regents. The payment was an integral part of the transaction, as described in the Agreement. As set forth in the Agreement, the transaction was structured in the form of a quid pro quo, because the UC Regents would not receive appellant's $150,000 unless the UC Regents were participants in the transaction with appellant – a transaction structured for purposes of the appellant receiving the tax benefit discussed in Issue 1. The claimed charitable deduction is not allowable simply because students in the Department of Computer Science and Electrical Engineering in the College of Engineering at UC Berkeley ultimately benefitted from the $150,000, which was apparently spent on the purchase of educational equipment that the students would use in their studies.

[13] Federal income tax implications, which may have been significant, are not considered or discussed.

Appellant has offered nothing to refute FTB's contention that appellant paid the UC Regents $150,000 as an accommodation fee for engaging in the transaction so that appellant could obtain tax benefits. Appellant has offered nothing to refute the contention that the transfer was motivated primarily by the incentive of substantial tax benefits and not detached and disinterested generosity. Consequently, the transfer does not qualify for a charitable contribution deduction. Appellant has not shown FTB has improperly disallowed appellant's revised claimed charitable deduction of $117,414 pursuant to IRC section 170.

Issue 4: Whether the NEST penalty under R&TC section 19774 was properly imposed.

R&TC section 19774(a) provides that, "[i]f a taxpayer has a noneconomic substance transaction understatement for any taxable year, there shall be added to the tax an amount equal to 40 percent[14] of the amount of that understatement."[15] This penalty is commonly referred to as a NEST penalty. A "noneconomic substance transaction" includes the following:

1. 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 when the taxpayer lacks a valid nontax California business purpose for entering into the transaction. (R&TC, § 19774(c)(2)(A).)
2. Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance, within the meaning of Section 7701(o) of the [IRC],[16]

[14] This penalty may be 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).) This provision does not apply because appellant made no such disclosure on his 2007 return.

[15] The term "noneconomic substance transaction understatement" is defined as "any amount which would be an understatement under Section 6662A(b) of the [IRC], as modified by subdivision (b) of [R&TC] Section 19164.5 if Section 6662A(b) of the [IRC] were applied by taking into account items attributable to noneconomic substance transactions rather than items to which Section 6662A(b) applies." (R&TC, § 19774(c)(1).)

[16] IRC section 7701(o) provides that under the economic substance doctrine, a transaction shall be treated as having economic substance only if 1) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and 2) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

relating to clarification of economic substance doctrine." (R&TC, § 19774(c)(2)(B).)[17]

Once a NEST penalty has been proposed and the NPA has been sent, only FTB's Chief Counsel "may compromise all or any portion of that penalty." (R&TC, § 19774(d)(1).) Notwithstanding any other law or rule of law, any determination by FTB's Chief Counsel with respect to the NEST penalty may not be reviewed in any administrative or judicial proceeding. (R&TC, § 19774(d)(3).)

FTB determined, and we concur, that the sale of appellant's term income interest in the Trust to UC Regents should be disregarded for tax purposes because it lacked economic substance. As addressed in our discussion of Issue 3, above, we conclude that FTB properly disallowed the revised claimed charitable deduction of $117,414. The amount of the NEST penalty is calculated based on the amount of the reportable transaction understatement, as defined in IRC section 6662A. FTB calculated the imposed NEST penalty of $86,174 as 40 percent of the proposed additional tax of $215,435, excluding the mental health tax of $14,492. We conclude that FTB properly calculated the NEST penalty.

Issue 5: Whether the interest-based penalty under R&TC section 19777 was properly imposed.

R&TC section 19777(a) provides that if a taxpayer has been contacted by FTB concerning an ATAT, and there is a deficiency attributable to an ATAT, then FTB shall impose a penalty equal to 100 percent of the interest payable for the period beginning on the due date of the payment of the tax and ending on the date that the NPA is mailed.[18] An ATAT includes any transaction to which R&TC section 19774 (i.e., the NEST penalty) applies. (R&TC, § 19777(b)(5).) As discussed in Issue 4, we conclude that FTB properly imposed the NEST penalty pursuant to R&TC section 19774. For purposes of the interest-based penalty, this transaction is therefore an ATAT. Furthermore, the AIPS properly notified appellant regarding the ATAT, as well as the applicability of the NEST and interest-based penalties. Lastly, FTB proposed a deficiency assessment attributable to the ATAT as reflected in the NOA. We

[17] R&TC section 19774(c)(2)(B), was added effective March 24, 2011, and is effective for NPAs mailed on or after March 24, 2011. This provision applies to this appeal, because FTB issued the NPA to appellant on July 2, 2013.

[18] As amended, R&TC section 19774 is effective on March 24, 2011, for NPAs mailed on or after March 24, 2011. This provision applies to this appeal, because FTB issued the NPA to appellant on July 2, 2013.

therefore conclude that FTB properly imposed the interest-based penalty under R&TC section 19777.

HOLDINGS

1. Appellant has not shown that FTB improperly determined that his reported sale of his term income interest in the Trust to the UC Regents should be disregarded for tax purposes because it lacked economic substance.
2. Appellant has not shown that FTB erroneously determined that the correct amount of gain that he realized from the early termination of the Trust was $2,199,094.
3. Appellant has not shown he was entitled to a charitable deduction for a contribution to the UC Regents of $150,000.
4. The NEST penalty was properly imposed.
5. The interest-based penalty was properly imposed.

DISPOSITION

FTB's action is sustained.

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

We concur:

DocuSigned by:
Jeff Angeja
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Jeffrey G. Angeja
Administrative Law Judge

DocuSigned by:
Kenneth Gast
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Kenneth Gast
Administrative Law Judge

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