OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of: TAMMY MARIE MCKEE

) OTA Case No. 18063305

OPINION

Representing the Parties:

For Appellant: Chris Engelmann, TAAP representative

For FTB: Brian Werking, Tax Counsel III

For Office of Tax Appeals: Matthew D. Miller, Tax Counsel III

A. VASSIGH, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045 Tammy Marie McKee (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing $17,958 of additional tax and an accuracy-related penalty of $3,591.60, plus applicable interest, for the 2014 tax year.

Office of Tax Appeals Administrative Law Judges Kenneth Gast, Sara A. Hosey, and Amanda Vassigh held an oral hearing for this matter in Cerritos, California, on December 19, 2019. Appellant appeared via telephone conference call and Mr. Chris Engelmann, her representative, attended the hearing in-person. At the conclusion of the hearing, the record was closed, and this matter was submitted for a decision.

ISSUES

1. Whether appellant has shown error in FTB’s proposed assessment, which is based on a federal determination.
2. Whether appellant has demonstrated that the accuracy-related penalty should be abated.

1 Appellant filed her own appeal letter. Subsequent representation was provided by the Tax Appeals Assistance Program (TAAP).
FACTUAL FINDINGS

1. Appellant filed a timely 2014 California income tax return claiming the head of household filing status and exemption credits, reporting federal adjusted gross income (AGI) of $17,055, less California adjustments (subtractions) and itemized deductions, for a reported California taxable income of $0. After reporting withholding credits of $196, appellant claimed a $196 overpayment, which FTB refunded.

2. The Internal Revenue Service (IRS) provided information to FTB indicating that the IRS significantly increased appellant’s reported Schedule E pass-through income, which increased appellant’s 2014 federal taxable income. The IRS assessed additional tax and imposed an accuracy-related penalty.

3. To the extent applicable under California law, FTB followed the federal changes provided by the IRS and made adjustments to appellant’s 2014 California taxable income.

4. FTB issued a Notice of Proposed Assessment (NPA) for 2014. The NPA showed an increase in appellant’s taxable income due to the increase in Schedule E pass-through income. The NPA indicated proposed additional tax of $17,958 and an accuracy-related penalty of $3,591.60, plus applicable interest.

5. Appellant timely responded to the NPA by submitting IRS forms from a federal audit of Egg Etc., LLC (Egg Etc.), which list appellant as a 90 percent owner. Appellant provided Form 4605, “Examination Changes – Partnerships, Fiduciaries, S Corporations, and Interest Charge Domestic Internal Sales Corporations,” Form 886-S, “Partners’ Share of

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2 FTB also made other changes to appellant’s 2014 tax return, but since appellant has not disputed them, they will not be discussed in this opinion.

3 Form 4605, “Examination Changes – Partnerships, Fiduciaries, S Corporations, and Interest Charge Domestic Internal Sales Corporations,” is an IRS form which provides an explanation of all adjustments due to a federal audit.
Income, Deductions, and Credits,”4 and Form 886-Z, “TEFRA Partners’ Shares of Income.”5 FTB treated appellant’s submission as a timely protest.

6. FTB sent a letter to appellant acknowledging her protest and requesting a revised IRS report or any additional information to support her position. When FTB did not receive a response, it issued a Notice of Action affirming its position. This timely appeal followed.

**DISCUSSION**

Issue 1 – Whether appellant has shown error in FTB’s proposed assessment, which is based on a federal determination.

R&TC section 18622(a), provides that a taxpayer shall either concede the accuracy of a federal determination or state wherein it is erroneous. A deficiency assessment based on a federal audit report is presumptively correct, and the taxpayer bears the burden of proving that the determination is erroneous. (Todd v. McColgan (1949) 89 Cal.App.2d 509; Appeal of Brockett (86-SBE-109) 1986 WL 22731.) Unsupported assertions are not sufficient to satisfy a taxpayer’s burden of proof with respect to an assessment based on a federal action. (Appeal of Magidow (82-SBE-274) 1982 WL 11930.) It is well-established that the failure of a party to introduce evidence which is within his or her control gives rise to the presumption that, if provided, it would be unfavorable. (Appeal of Cookston (83-SBE-048) 1983 WL 15434.)

Here, FTB properly proposed an assessment of additional tax based on a federal adjustment for the 2014 tax year. Appellant contends that the IRS audit adjustments is due to her family’s use of Egg Etc., of which appellant was a 90 percent owner during 2014, to operate a restaurant. She contends that she was not involved in running the restaurant business, and her family sold the business without her involvement by using someone else’s social security number, leaving her with debt. In support of her contention, appellant provides copies of IRS Forms 4605 and 886-Z. Form 886-Z lists appellant as a 90 percent owner of Egg Etc., and a

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4 Form 886-S, “Partners’ Share of Income, Deductions, and Credits,” is an IRS form which lists each investor’s name and Taxpayer Identification Number (TIN) and is used to show each investor’s pro rata share of the corrected items in an IRS audit.

5 Form 886-Z, “TEFRA Partners’ Shares of Income,” is an IRS form which provides an explanation of partners’ corrected partnership items and penalties due to a federal audit under TEFRA, which stands for the Tax Equity and Fiscal Responsibility Act of 1982. In pertinent part, TEFRA established consolidated examination procedures that determine the tax treatment of partnership items at the partnership level for partnerships and limited liability companies (LLCs) that are classified as partnerships for tax purposes.
person appellant indicates is her sister as a 10 percent owner. However, Form 886-Z lists a partner TIN for appellant that does not match her social security number. Appellant contends that the Form 886-Z is “a copy of the legal owners of [Egg Etc.] in 2014 and somehow it has my name and someone else’s SSN, that is how they sold the business without me.” Appellant does not provide any documents to substantiate her contentions, such as Egg Etc.’s tax returns, books and records, or other source documents to substantiate her claimed losses from the business.\(^6\)

FTB provides a copy of appellant’s 2014 California tax return on which appellant claimed a nonpassive loss of $14,893 from Egg Etc. Internal Revenue Code (IRC) section 469 disallows the deductibility of certain losses generated by passive activities except to offset income from other passive activities. (IRC, § 469(a).) However, this limitation does not apply to nonpassive activities, i.e. activities in which the taxpayer materially participates. Material participation in an activity is involvement that is regular, continuous, and substantial. (IRC, § 469(h)(1)(A)-(C); see also Treas. Reg. § 1.469-5T.) Therefore, by deducting a nonpassive loss of $14,893 from Egg Etc., appellant claimed involvement in Egg Etc. that is regular, continuous, and substantial. As such, appellant’s return, signed under penalty of perjury, contradicts her claim that she did not materially participate in the business.

Additionally, FTB provides three records filed with the California Secretary of State: (1) Egg Etc.’s 2005 Articles of Organization, executed by appellant as the organizer, and listing appellant as the agent for service of process for Egg Etc.; (2) Egg Etc.’s 2005 Statement of Information, executed by appellant, and listing appellant as Egg Etc.’s chief executive officer (CEO), its sole manager, and its agent for service of process; and (3) Egg Etc.’s 2011 Statement of Information, executed by appellant, and listing appellant as Egg Etc.’s CEO and its agent for service of process, and a person appellant indicates is her sister, as its sole manager.\(^7\) As with the tax return appellant filed, these documents indicate that appellant participated in the business.

Appellant’s claim that she was not involved is contradicted by her own 2014 tax return and the Secretary of State records that she executed on behalf of Egg Etc. Appellant was

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\(^6\) Additionally, appellant relies on Appeal of Ralite Lamp Corp. (90-SBE-004) 1990 WL 117932 (Ralite), for the proposition that a sole limited liability company (LLC) member cannot be held personally responsible for LLC taxes. Ralite is inapplicable to this appeal because Ralite involved transferee liability of shareholders for corporate franchise tax, whereas this case involves personal income tax liability based on being a member of an LLC. Furthermore, Ralite does not support the proposition for which appellant contends.

\(^7\) Egg Etc.’s Articles of Organization and its 2005 Statement of Information lists appellant as Tammy Ransdell.
provided an opportunity to provide evidence showing error in FTB’s determination; however, appellant has not presented any argument or evidence establishing error in the final federal assessment or FTB’s determination based on the final federal assessment. Therefore, we conclude that appellant has not satisfied her burden of showing error in the final federal assessment or overcome the presumption of correctness in the FTB’s determination based on the final federal assessment.

Issue 2 – Whether appellant has demonstrated that the accuracy-related penalty should be abated.

R&TC section 19164, which incorporates provisions of IRC section 6662, provides for an accuracy-related penalty of 20 percent of the applicable underpayment. IRC section 6662(b) provides, in relevant part, that the penalty applies to the portion of the underpayment attributable to (1) negligence or a disregard of rules and regulations, or (2) any substantial understatement of income tax. (IRC, § 6662(b)(1)-(2).)

There are three exceptions to the imposition of the accuracy-related penalty. The taxpayer bears the burden of proving any defenses to the imposition of the accuracy-related penalty. (Recovery Group, Inc., et al. v. Commissioner, 99 T.C.M. (CCH) 1324.) Under the first exception, the accuracy-related penalty shall be reduced by the portion of the understatement attributable to the tax treatment of any item if there is or was substantial authority for such treatment. (IRC, § 6662(d)(2)(B)(i).) Under the second exception, the accuracy-related penalty shall be reduced by the portion of the understatement attributable to a tax treatment of any item if the relevant facts affecting the item’s tax treatment are adequately disclosed, and there is or was a reasonable basis for the tax treatment of such item. (IRC, § 6662(d)(2)(B)(ii).) The exception for adequate disclosure, however, will not apply if the taxpayer failed to keep adequate books or records or the taxpayer failed to substantiate items on the return. (Treas. Reg. § 1.6662-3(c)(1).) Under the third exception, the accuracy-related penalty will not be imposed to the extent that a taxpayer shows a portion of the underpayment was due to a reasonable cause and that the taxpayer acted in good faith with respect to such portion of the underpayment. (IRC, § 6664(c)(1); Treas. Reg. §§ 1.6664-1(b)(2), 1.6664-4.)

A determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis and depends on the pertinent facts and circumstances, including the taxpayer’s efforts to assess the proper tax liability, the taxpayer’s knowledge and experience, and the extent to which the taxpayer relied on the advice of a tax professional. (Treas. Reg.
§ 1.6664-4(b.) Generally, the most important factor is the extent of the taxpayer’s effort to assess the proper tax liability. (Ibid.) Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer. (Treas. Reg. § 1.6664-4(b)(1).)

FTB correctly imposed an accuracy-related penalty of 20 percent of the applicable underpayment in the amount of $3,591.60 (i.e., $17,958 × .20). Appellant has provided no argument or evidence establishing that she acted reasonably in determining her 2014 tax liability. Appellant has failed to show either substantial authority to justify the understatement or adequate disclosure of the understatement specifying a reasonable basis. Further, appellant’s 2014 federal Account Transcripts show no indication that the federal accuracy-related penalty for the respective tax year was revised or abated. Accordingly, appellant has failed to produce credible and competent evidence to show that FTB improperly imposed the accuracy-related penalty based on the final federal audit, or that the penalty should be abated.
HOLDINGS

1. Appellant has not shown error in FTB’s determination or the federal adjustment on which it is based.
2. Appellant has not demonstrated that the accuracy-related penalty should be abated.

DISPOSITION

FTB’s action is sustained.

We concur:

Kenneth Gast
Administrative Law Judge

Sara A. Hosey
Administrative Law Judge

Date Issued: 2/4/2020