OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 19024290
M. KOHL AND	)
V. KOHL	)
	)
	)

OPINION

Representing the Parties:

For Appellants: James Daloisio

For Respondent: Gi Nam, Tax Counsel

J. LAMBERT, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19324, M. Kohl and V. Kohl (appellants) appeal an action by respondent Franchise Tax Board (FTB) in denying appellants' claim for refund of a notice and demand (demand) penalty of $1,222 and a late filing penalty of $220 for the 2016 tax year.

Appellants waived their right to an oral hearing; therefore, the matter is being decided based on the written record.

ISSUES

1. Whether FTB properly imposed the demand penalty for the 2016 tax year.
2. Whether appellants have shown reasonable cause for failing to timely respond to the Demand for Tax Return (Demand) for the 2016 tax year.
3. Whether appellants have shown that the late filing penalty should be abated for the 2016 tax year.

FACTUAL FINDINGS

1. FTB issued a Request for Tax Return (Request) to appellants on May 9, 2017, for the 2015 tax year. Appellants failed to respond to the Request. Therefore, FTB issued a Notice of Proposed Assessment (NPA) on October 30, 2017, for the 2015 tax year.

2. Appellants made a payment of $800 to FTB on June 9, 2017, for the 2016 tax year. However, FTB applied the payment to the 2015 tax year.
3. FTB issued a Demand to appellants on April 3, 2018, for the 2016 tax year, which demanded that appellants file a return by May 9, 2018. Appellants failed to timely respond to the Demand. Therefore, FTB issued an NPA on June 4, 2018, for the 2016 tax year which included a demand penalty and a late filing penalty.
4. Appellants filed their 2016 return on July 15, 2018, and filed a claim for refund,[1] which FTB denied. This timely appeal followed.

DISCUSSION

Issue 1: Whether the FTB properly imposed the demand penalty for the 2016 tax year.

If any taxpayer fails or refuses to furnish any information requested in writing by FTB or fails or refuses to make and file a return upon notice and demand by FTB, then, unless the failure is due to reasonable cause, FTB may add a penalty of 25 percent of the amount of any tax assessment pertaining to the assessment of which the information or return was required. (R&TC, § 19133.) Pursuant to California Code of Regulations, title 18, section (Regulation) 19133, however, FTB will only impose a demand penalty if: (1) the taxpayer fails to respond to a current Demand in the manner prescribed; and (2) FTB previously proposed an assessment of tax under the authority of R&TC section 19087, subdivision (a), after the taxpayer failed to timely respond to a Request or a Demand in the manner prescribed, at any time during the four-taxable-year period preceding the taxable year for which the current Demand is issued. (Cal. Code Regs., tit. 18, § 19133(b).)

FTB contends that the demand penalty for 2016 was properly imposed, pursuant to Regulation 19133, because appellants were issued a Request and an NPA for the 2015 tax year. Specifically, FTB contends that Regulation 19133 should be interpreted consistently with Example 2 of subdivision (d), which indicates that the prior Request or Demand and NPA must have been issued for one of the four tax years preceding the tax year of the current Demand,[2] as

[1] FTB issued a Notice of Tax Change following receipt and processing of appellants' return, adjusting the demand penalty to $1,222, and the late filing penalty to $220, amounts which appellants paid.

[2] Subdivision (d) presents an example where a 2001 demand penalty is properly imposed because the prior Request and NPA were issued for the 1999 tax year, which is within one of the four taxable years prior to the example's current tax year, 2001.

opposed to subdivision (b) which, by the use of the term "during," could arguably be interpreted as requiring that the previous NPA have been issued on a date falling within the 48-month time period preceding the current tax year.

If possible, we must read regulations as a whole so that all of their parts are given effect. (*Butts v. Bd. of Trustees of Cal. State Univ.* (2014) 225 Cal.App.4th 825, 835 (*Butts*).) It is presumed that the inclusion of regulatory examples was not intended to be surplusage.[3] (*Major v. Silna* (2005) 134 Cal.App.4th 1485, 1494.) A regulation must be interpreted in accordance with its examples using applicable canons of statutory construction. (*People v. Arias* (2008) 45 Cal.4th 169, 180 & 182.) A plain language reading of both the example and non-example text of a regulation may resolve, or result in, an ambiguity. (See, e.g., *U.S. v. Intercontinental Industries, Inc*. (6th Cir. 1980) 635 F.2d 1215, 1222 ["the regulation, in the light of the illustration, is ambiguous"]); *Indian River County, Florida v. Dept. of Transportation* (2018) 348 F.Supp.3d 17, 40-41 ["Fortunately, the same IRS regulations provide examples that answer any lingering questions . . . ."].) Because an ambiguity is created by the plain language of subdivisions (b) and (d), we may look to extrinsic aids, including the history and purpose of the regulation.[4] (*Butts*, *supra*, 225 Cal.App.4th at p. 835.)

The regulation's purpose is to avoid penalizing first-time nonfilers who file "in the following tax year" and to penalize "only repeat nonfilers." (Statement of Reasons.) FTB rejected alternate versions of the regulation that "failed to target repeat nonfilers." (*Ibid*.) On the other hand, taxpayers "who fail to file income tax returns for the first time would not be penalized." (Economic and Fiscal Impact Statement.) Thus, the purpose of the regulation is to penalize repeat nonfilers, unambiguously defined as taxpayers who fail to file more than once, while allowing only first-time nonfilers to escape the penalty.

[3] Quasi-legislative regulations, such as Regulation 19133 and its examples, are not mere interpretive rules, but are the substantive product of a delegated legislative power conferred on FTB and are as binding as statutes. (*Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1, 8 & 10; R&TC, § 19503(a).) Regulation 19133 filled the "gap" in the statute as to when FTB "may add" the penalty by providing a new legal standard as to when the penalty will or will not be imposed. (See *GMRI, Inc. v. CDTFA* (2018) 21 Cal.App.5th 111, 194; R&TC, § 19503(a).) A regulation adopted by an administrative agency pursuant to its delegated rulemaking authority has the force and effect of law. (*California Teachers Assn. v. California Com. on Teacher Credentialing* (2003) 111 Cal.App.4th 1001, 1008.)

[4] See also *Kisor v. Wilkie* (2019) 139 S.Ct. 2400, 2415 [We must carefully consider the "text, structure, history, and purpose of a regulation" to resolve ambiguities.].)

FTB contemporaneously incorporated procedures to "differentiate between first time nonfilers and repeat nonfilers." (Staff Request for Permission to Proceed.) FTB sends a Request to a first-time nonfiler, which does not trigger the penalty. If a first-time nonfiler fails to file more than once, a Demand is issued, which triggers the penalty.[5] Here, FTB could not have known that the 2016 return was unfiled until after the April 15, 2017 due date, so an NPA could not have been issued prior to 2016. Therefore, given that tax returns are never due until the following tax year, it would be impossible under the subdivision (b) interpretation to impose the demand penalty on a repeat nonfiler who fails to file in consecutive years, such as appellants, which is clearly contrary to the purpose of the regulation.

In *Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1, 12-13, the California Supreme Court determined that the weight given to an agency's interpretation of a regulation depends on certain factors, including whether the agency is interpreting its own regulation, and whether the interpretation has been consistently maintained or was contemporaneous with the enactment of the regulation. Here, FTB's interpretation of its own regulation is the only interpretation consistent with the regulatory intent and is clearly expressed in FTB's contemporaneously implemented procedures. Accordingly, we will defer to FTB's interpretation and, thus, the demand penalty was properly imposed.

With regard to the dissent, the issue of whether a regulation is "persuasive authority" as described in *Cook v. Commissioner* (7th Cir. 2001) 269 F.3d 854, 858, is inapplicable here because whether a regulation is consistent with the underlying statute and therefore "persuasive authority" is a federal standard for determining whether a regulation is valid. (See also *Freeport Country Club v. U.S.* (7th Cir. 1970) 430 F.2d 986, 992; *Fawcus Mach. Co. v. U.S.* (1931) 282 U.S. 375, 378.) If a federal court finds that a federal regulation is consistent with its underlying statute, then the court must conclude that the regulation is "persuasive authority".[6] (*Gerdes v. U.S.* (N.D.Cal. 1980) 498 F.Supp. 385, 388.) Such a federal standard on the validity of a federal

[5] In creating the regulation, FTB relied on its "Subsequent Year Project", which investigated whether taxpayers who received a Demand and NPA for one tax year, filed for the subsequent tax year. FTB proposed that first-time nonfilers, as defined by the study, receive a reminder, not a Demand, which was supported by the interested members of the public. FTB later requested to extend the look-back period to four tax years.

[6] The statutory test applied by courts in California in evaluating the validity of regulations is similar to the above-described federal test applicable to federal courts. (See Gov. Code, § 11342.2.)

regulation is inapplicable here, however, as we are only addressing the interpretation of a California regulation.

Issue 2: Whether appellants have shown reasonable cause for failing to timely respond to the Demand for Tax Return for the 2016 tax year.

When FTB properly imposes a demand penalty, the law presumes that the penalty was imposed correctly. (*Appeal of Goodwin* (97-SBE-003) 1997 WL 258474.) The burden is on taxpayers to prove that reasonable cause prevented them from responding to the Demand. (*Id*.) To establish reasonable cause, a taxpayer must show that the failure to respond to a Demand occurred despite the exercise of ordinary business care. (*Appeal of Bieneman* (82-SBE-148) 1982 WL 11825.) The taxpayer's reason for failing to respond must be such that an ordinarily intelligent and prudent businessperson would have acted similarly under the circumstances. (*Appeal of Halaburka* (85-SBE-025) 1985 WL 15809.)

Difficulties suffered by a taxpayer, such as the serious illness of the taxpayer or a member of his or her immediate family, is a circumstance which the courts have acknowledged may constitute reasonable cause. (*McMahan v. Commissioner* (2nd Cir. 1997) 114 F.3d 366, 369.) For the difficulties to constitute reasonable cause, they must continuously prevent the taxpayer from timely complying with the statutory requirement. (*Appeal of Halaburka, supra*.)

Appellants assert that they have reasonable cause for the failure to timely file and respond to the Demand because they suffered a series of hardships going back to 2013 that caused them to be unable to timely manage their affairs. Appellants state that these hardships included numerous issues related to, for example, their family's health, as well as increased hours at work.[7]

While we are sympathetic to appellants' hardships, they provide no evidence or documentation establishing that they were continuously prevented from responding to the Demand. Appellants argue that their contentions should not be disregarded due to their failure to provide documents and records. However, appellants have the burden of proof to provide evidence to support their contentions. Given the basis of the claimed hardships, such documentation should be readily available. Furthermore, many of the events that appellants describe took place in the years prior to the period at issue. As such, we have no basis to find

[7] Appellants argue that the penalties should abated due to a history of compliance. However, there is no provision in the Revenue and Taxation code that would allow us to abate a penalty based on such circumstances.

reasonable cause, as appellants provide no evidence that they were continuously prevented from responding to the Demand or that their hardships caused them to be incapacitated during the period at issue.

Additionally, appellants were able to earn substantial wages during the 2016 tax year. Penalty abatement is inapplicable if the difficulties at issue simply cause taxpayers to sacrifice the timeliness of one aspect of their business affairs to pursue other aspects. (*Appeal of Orr* (68- SBE-010) 1968 WL 1640.) A taxpayer's selective inability to perform tax obligations, while participating in regular business activities, does not establish reasonable cause. (*Watts v. Commissioner* (1999) T.C. Memo. 1999-416.) As such, because appellants worked and earned wages during the relevant period at issue, they were not prevented from timely responding to the Demand or filing their tax return. Instead, they sacrificed their filing obligation in order to pursue other aspects of their business affairs, which does not establish reasonable cause.

Additionally, appellants were on notice that they were failing to fulfill their filing requirement and that penalties could be issued if they failed to timely file and respond to the Demand. Appellants received the 2015 Request on May 9, 2017, before the 2016 extended filing deadline of October 15, 2017, and before the 2016 Demand was issued on April 3, 2018. These notices stated that a demand penalty and a late filing penalty could be issued if appellants failed to comply. Appellants, however, failed to either timely file or respond to the Demand. Accordingly, appellants have not shown reasonable cause such that the penalty may be abated.

Issue 3: Whether appellants have shown that the late filing penalty should be abated for the 2016 tax year.

R&TC section 19131 provides that a late filing penalty shall be imposed when a taxpayer fails to file a tax return on or before its due date, unless the taxpayer establishes that the late filing was due to reasonable cause and not due to willful neglect. When respondent imposes a late filing penalty, the law presumes that the penalty was imposed correctly. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Goodwin*, *supra*.) To establish reasonable cause, a taxpayer must show that the failure to file a return on time occurred despite the exercise of ordinary business care. (*Appeal of Tons* (79-SBE-027) 1979 WL 4068; *Appeal of Bieneman*, *supra*.) The taxpayer's reason for failing to file timely must be such that an ordinarily intelligent and prudent businessperson would have acted similarly under the circumstances. (*Appeal of Cummings* (60-SBE-040) 1960 WL 1418.)

Appellants' contentions for the late filing penalty are the same as those for the demand penalty.[8] For the same reasons as described above for the demand penalty, appellants have not shown reasonable cause such that the penalty may be abated.

HOLDINGS

1. FTB properly imposed the demand penalty.
2. Appellants have not shown reasonable cause for failing to respond to the Demand.
3. Appellants have not shown reasonable cause for failing to timely file.

DISPOSITION

FTB's action is sustained.

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Josh Lambert
Administrative Law Judge

I concur:

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Richard Tay
Administrative Law Judge

[8] Appellants argue that the penalties were not properly calculated because they sent a payment of $800 to FTB on June 9, 2017, for the 2016 tax year, but FTB mistakenly applied the payment to the 2015 tax year. Because the $800 was untimely paid after the payment due date of April 15, 2017, the calculation of the late payment penalty is not affected.

D.BRAMHALL, concurring in part and dissenting in part:

I first agree with the majority that Franchise Tax Board (FTB) action with respect to the late filing penalty should be sustained.

I disagree with the conclusion reached by the majority on the question of whether FTB properly imposed the demand penalty for tax year 2016. As is noted in the majority opinion, the issue involves the question of how to resolve an ambiguity between language in subdivision (b) – use of the term "during" – and Example 2, which requires the term "during" to be construed to mean "for." My disagreement with the majority rests in how to analyze the resolution of that ambiguity. As articulated below, I would refuse to apply Example 2.

In the majority analysis, it is concluded that its view of the ambiguity is that it must be resolved in favor of the agency (FTB) interpretation as that interpretation is consistent with the regulatory intent. However, I disagree with that foundational analysis.

As to my view of the proper resolution of the ambiguity identified, I look to the most recent pronouncement on the subject, from the U.S. Supreme Court, *Kisor v. Wilkie* (2019) 139 S. Ct. 2400 (*Kisor*) which addresses directly the question of when deference to an agency interpretation is and is not appropriate.[1] Historically, citing *Auer v Robbins* (1997) 519 U.S. 452 and similar cases, courts have routinely deferred to an agency interpretation of its ambiguous regulations. *Kisor* now stands for a stricter analysis before deference is afforded. First, a genuine ambiguity must be found to exist after applying traditional tools of construction. Secondly, even if an ambiguity is found, the agency interpretation must still fall within the bounds of reasonable interpretation.

In the case of California Code of Regulations, title 18, section (Regulation) 19133, the language of subdivision (b) requires, unambiguously, that a prior demand notice and NPA have been issued **during** a four-year period prior to the tax year for which a demand penalty is assessed. Example 1 in subdivision (d) illustrates the timing of a prior demand notice. Based on the timing reflected in Example 1, Example 2 in subdivision (d) is inconsistent with the clear language of subdivision (d). In my view, Example 2 is an incorrect interpretation of the clear language concerning the required timing of a prior demand notice and NPA.

[1] The majority also relies upon the *Kisor* decision and concludes that an ambiguity exists, and that Example 2 reflects a reasonable interpretation of regulatory intent.

As stated in *Kisor*, "[d]eference in that circumstance would 'permit the agency, under the guise of interpreting a regulation, to create *de facto* a new regulation.'" Therefore, to impose the demand penalty in such a situation should be found unreasonable as inconsistent with the rule maker's intention and plain reading of subdivision (b) of the Regulation 19133. Accordingly, I would reverse the action of the FTB and grant appellant a refund for the demand penalty and associated interest.

To arrive at its conclusion the majority opinion relies on extrinsic evidence, the FTB's stated intention for the adoption of Regulation 19133. That intent is to define when FTB "may" impose the demand penalty and is described as providing relief for first-time nonfilers and penalties for "repeat nonfilers." The majority errs, however, in its assertion that the term "repeat nonfiler" is unambiguously defined as taxpayers who fail to file more than once. Under even the FTB's interpretation of the Regulation, not all multi-year nonfilers are subject to the demand penalty.[2]

In its Notice of Proposed Rulemaking, a repeat nonfiler is defined as "an individual who has received a proposed assessment of tax **after receiving** and failing to respond to either a request for tax return or a demand for tax return **within the previous four years**." (Emphasis added.) This timing requirement clearly demands a temporal relationship between the current year and prior year demand notices.

First, I note that the term "within the previous four years" is consistent with the use of the term "during" used in subdivision (b). However, it is inconsistent with a substitution of the term "for" as would be required to uphold the FTB interpretation as reflected by Example 2. Additionally, nothing about the so-called subdivision (b) interpretation is inconsistent with the purpose of avoiding the penalty on first-time nonfilers, even though that interpretation might also excuse some multiple year nonfilers, as would be the result in case at hand. As I read the intended definition of a "repeat nonfiler," reflected in FTB's Notice of Proposed Rulemaking, appellants are not a repeat nonfilers within the meaning of the Regulation 19133. Accordingly, I disagree that the interpretation as set forth in Example 2 is consistent with a clear intention.

[2] For example, a repeat nonfiler with more than four years between events of non-compliance would not be a repeat nonfiler under either reading of the Regulation.

My view is that Example 2 within the Regulation is an improper illustration of the Regulation, as reflected by the language in subdivision (b). Further, there can be no dispute that OTA has jurisdiction to interpret a regulation, as is acknowledged in the majority opinion.

Further, in *Cook v. Commissioner* (2001) 269 F.3d 854, 858 (*Cook*) the court only gave conditional acceptance to the view that examples in a regulation are persuasive authority when it stated "examples set forth in regulations remain persuasive authority so long as they do not conflict with the regulations themselves." Since I view the Example 2 as in unambiguous conflict with the (b)(2) wording, I view the example as non-persuasive. However, the majority argues that the *Cook* review standard is inapplicable in this matter, based at least in part on the view that OTA does not have the same review standards as do federal tribunals.[3] I disagree since I also disagree with the underlying position in the majority opinion on the extent of OTA's authority in carrying out its duties to determine the correct legal results in appeals of FTB determinations. (See Cal. Code Regs., tit. 18, § 30103.) In that role we act as an independent, quasi-judicial body and should be viewed as having similar review authority as a court, subject of course to further judicial review where clearly courts have the ultimate authority to construe a statute or a regulation.

Accordingly, I would hold that FTB did not properly impose the demand penalty and would abate the same for tax year 2016.

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Douglas Bramhall
Administrative Law Judge

Date Issued: 3/30/2020

[3] I also note that several federal level cases are cited in the majority with reference to review standards so how we are to distinguish between when and when not to rely on federal court authority is unclear.