OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18042988
LA ROSA CAPITAL RESOURCE, INC.	)
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	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Joseph Petrucelli, LL.M.
For Respondent:	Judy F. Hirano, Tax Counsel IV
Office of Tax Appeals:	Mai C. Tran, Tax Counsel IV

J. JOHNSON, Administrative Law Judge: Pursuant to California Revenue and Taxation Code (R&TC) section 19045, appellant La Rosa Capital Resource, Inc., appeals an action by respondent Franchise Tax Board in proposing an assessment of the noneconomic substance transaction (NEST) penalty of $18,900 for the 2007 tax year.

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

ISSUE

Whether appellant has demonstrated respondent erred in imposing the NEST penalty.

FACTUAL FINDINGS

Background

1. During the year at issue, Mr. La Rosa worked for several companies that provided logistics for freight delivery and received wages totaling $687,866 from those entities.

Entity Formation

2. At some point prior to July 21, 2005, Mr. La Rosa formed the VLR Trust (La Rosa Kids Trust 1)[1] for the benefit of his children. The trustee of the La Rosa Kids Trust 1 was Mr. La Rosa's son. The trust owned the stock of a C corporation that was engaged in the trucking and logistics business in which Mr. La Rosa was then involved.

3. Mr. La Rosa formed the Guardia Trust (La Rosa Kids Trust 2) in 2005, and listed Mr. La Rosa's children as the beneficiaries with Mr. La Rosa as the trustee. The La Rosa Kids Trust 2 was amended on May 7, 2007, identifying Mr. La Rosa's business partner as the trustee; however, the La Rosa Kids Trust 2's 2007 tax return reported Mr. La Rosa as the trust's sole fiduciary.

4. In December 2005, Infinity Strategic Resource Management, LLC (La Rosa Management LLC) was formed in Nevada. The members of La Rosa Management LLC were the La Rosa Kids Trust 2 (99 percent) and Mr. La Rosa (1 percent). Mr. La Rosa was the sole employee and manager of La Rosa Management LLC. La Rosa Management LLC registered to do business in California in December 2006 and was classified as a partnership for federal and California income tax purposes. La Rosa Management LLC dissolved in September 2013.

5. Mr. La Rosa engaged a law firm for estate planning relating to combining the two existing trusts without court approval, developing a method to add additional funds to the resulting trust to generate an estate tax deduction, and developing a business structure to act as a funding and capital source for new ventures. According to a November 2006 opinion letter (Opinion Letter), the law firm advised Mr. La Rosa to borrow funds from one of the trusts, use those funds to form an S corporation (i.e., appellant), form a management company owned by the other trust, and develop business so that funds flowed from the S corporation to the management company. The Opinion Letter noted that, as Mr. La Rosa intended to be an employee of the management company, due to Mr. La Rosa's highly specialized skills and being a key employee of the management company, the compensation paid by the S corporation to Mr. La Rosa would be "deemed

[1] There are numerous entities discussed herein that were created, owned, or otherwise controlled by Mr. La Rosa. For the purpose of illustrating the nature of the transaction discussed herein, these entities are referenced by their entity type and relation to Mr. La Rosa.

reasonable." The Opinion Letter further stated that, "[w]hile there is no specific 'IRS sanction' for the plan . . . payments made by the S corporation should be deductible provided services are rendered and the management company maintains funds with which it can pay indemnification claims."

6. On November 29, 2006, appellant was incorporated in Nevada. Appellant elected to be taxed as an S corporation on December 2, 2006. Mr. La Rosa was appellant's sole shareholder, chief executive, director, president, secretary, and treasurer. Appellant qualified to do business with the California Secretary of State on December 26, 2006. Appellant dissolved in September 2013.

Strategic Business Services Agreement

7. On November 29, 2006, appellant and La Rosa Management LLC entered into a Strategic Business Services Agreement (Service Agreement) wherein La Rosa Management LLC agreed to provide management and strategic business services to appellant beginning on November 29, 2006, and ending on December 31, 2007. The Service Agreement stated in part that La Rosa Management LLC would provide appellant with the following services: 1) general business management; 2) tax and audit; 3) business development; and 4) contract indemnification and guarantee. The Service Agreement provided that appellant would pay La Rosa Management LLC an annual flat fee of $1.5 million in advance of the services being rendered, and this amount would be allocated among services listed in an attached allocation schedule other than the guarantee and indemnification provisions. In addition, the Service Agreement provided that appellant would pay an initial fee of $350,000 for the guarantee and indemnification provisions of the agreement.

Payments Between the Entities

8. According to respondent's review of bank statements from 2007 for appellant, La Rosa Management LLC, and La Rosa Kids Trust 2, Mr. La Rosa transferred $3,150,000 from his personal bank account to appellant in 2007. Appellant then made deposits totaling $3,150,000 into La Rosa Management LLC's bank account. La Rosa Management LLC then transferred that amount to the La Rosa Kids Trust 2. La Rosa Kids Trust 2's records reflect a total of $1,770,000 was transferred from La Rosa Kids Trust 2 to Mr. La Rosa's

personal bank account. Additional amounts were transferred from La Rosa Kids Trust 2 to another related bank account.[2]

Tax Return and Audit

9. Appellant filed a 2007 California S corporation tax return, reporting gross receipts of zero, and taxable income of negative $3,150,000, and the minimum tax of $800. The loss was based on business expenses deductions consisting of business development expenses of $1,816,875, business management expenses of $979,375, guarantee fees of $50,000, indemnification of $300,000, and legal fees of $3,750. On that return, appellant also reported "Consulting" as its business activity and "Services" as its product or service. Appellant filed a 2008 California S corporation tax return, reporting gross receipts of zero, taxable income of zero, and the minimum tax of $800.

10. La Rosa Management LLC issued 2007 Schedules K-1 to its two partners, the La Rosa Kids Trust 2 and Mr. La Rosa. For the La Rosa Kids Trust 2, La Rosa Management LLC reported that the trust's proportionate share of gross receipts was $3,118,500 (i.e., the $3,150,000 received from appellant as revenue times the trust's 99 percent share). La Rosa Management LLC made a cash distribution of that amount to the La Rosa Kids Trust 2.

11. Mr. La Rosa filed a 2007 California individual tax return, reporting a flow-through loss of $3,150,000 from appellant as its sole shareholder.

Audit

12. Respondent audited appellant's 2007 tax return. Respondent determined that the Service Agreement and the related payments from appellant to La Rosa Management LLC had no business purpose. Respondent further determined that appellant failed to demonstrate that La Rosa Management LLC actually provided any services to appellant. Respondent found that appellant engaged in a circular transaction to provide appellant's sole shareholder, Mr. La Rosa, with ordinary business losses to offset Mr. La Rosa's earned income (i.e., wages from logistics and freight delivery companies). As a result,

[2] Appellant reportedly provided bank statements reflecting these transactions to respondent during the audit and protest periods, but not all of the statements were provided on appeal. Bank account information was reported in respondent's brief and partially supported by attached exhibits. Appellant does not contest the amounts reported.

respondent disallowed appellant's claimed business expense deductions arising from payments made to La Rosa Management LLC and imposed the NEST penalty.

13. Respondent issued a Notice of Proposed Assessment (NPA) to appellant for 2007, disallowing the $3,150,000 in deductions, which resulted in revising appellant's taxable income from negative $3,150,000 to zero. Respondent did not assess any additional tax, but it proposed to assess the NEST penalty of $18,900.

Protest

14. Appellant filed a timely protest letter, making generally the same arguments as being made here on appeal. Appellant's protest asserted that the purpose of the various activities described above was to allow Mr. La Rosa to pursue new business opportunities, safeguard assets from creditors, merge the two existing trusts, and provide financial support for the beneficiaries of the La Rosa Kids Trust 2. Appellant further asserted that Mr. La Rosa was at most a fiduciary of the La Rosa Kids Trust 2, Mr. La Rosa was not a beneficiary of the La Rosa Kids Trust 2, and Mr. La Rosa therefore did not receive the benefit of the La Rosa Kids Trust 2's funds.

15. After reviewing appellant's protest letter, respondent issued a Notice of Action to appellant affirming the NPA. Appellant then filed this timely appeal.

DISCUSSION

The NEST Penalty

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 of the amount of that understatement."[3]

A "noneconomic substance transaction" includes "[t]he 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." (R&TC, § 19774(c)(2)(A).) A transaction shall be treated as lacking economic substance if the

[3] 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).) Appellant made no such disclosure.

taxpayer does not have a valid nontax California business purpose for entering into the transaction. (*Ibid*.)

Once the NEST penalty is imposed and the NPA has been issued, only respondent'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 NEST penalty determination by respondent's Chief Counsel "may not be reviewed in any administrative or judicial proceeding." (R&TC, § 19774(d)(3).) Accordingly, although we are precluded by statute from abating the NEST penalty or reviewing a decision of respondent's Chief Counsel denying a request by appellant for abatement, our limited role does allow us to determine whether the penalty was properly imposed in the first place. We now turn to that issue.

Economic Substance Doctrine

The economic substance and sham transaction doctrines are judicial doctrines developed to prevent a taxpayer from reaping tax benefits from a transaction that lacks economic substance. (See *Casebeer v. Comm'r* (9th Cir. 1990) 909 F.2d 1360.) There are two types of shams: a sham in fact and a sham in substance. A sham in fact is a transaction that never occurred, while a sham in substance is a transaction that occurred but lacks the substance its form represents. (*Kirchman v. Comm'r* (11th Cir. 1989) 862 F.2d 1486, 1492.) In determining whether a transaction is a sham, courts have developed a two-part analysis: (1) whether the taxpayer has demonstrated a business purpose for engaging in the transaction other than tax avoidance; and (2) whether the taxpayer has shown that the transaction had economic substance beyond the creation of tax benefits. (*Casebeer v. Comm'r, supra*, 909 F.2d at p. 1363; *Appeal of Alyn* (2009-SBE-001) 2009 WL 2340393.) This two-part analysis is not a conjunctive test or "rigid two-step analysis," but rather "precise factors" that need to be weighed to determine whether the transaction had any practical economic effects other than the creation of tax losses. (*Casebeer v. Comm'r, supra*, 909 F.2d at p. 1363.)

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 p. 1364.) 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. (*Id.* 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.)

The transaction to be analyzed is the one that gave rise to the alleged tax benefit. (*Coltec Industries, Inc. v. United States* (Fed. Cir. 2006) 454 F.3d 1340, 1356.) A lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance. (*Id.* at p. 1355.) Additionally, the taxpayer bears the burden of proving that the transaction has economic substance. (*Ibid.*)

Business Purpose

Appellant asserts that it was formed to pursue new business activities. Appellant contends that Mr. La Rosa was interested in forming a business structure through which he could seek new business opportunities while separating the assets from the operations of the business. Appellant asserts that the purpose of its incorporation and subsequent Service Agreement with La Rosa Management LLC was to pursue a ranching business in Montana, but that business was abandoned prior to making a profit.

In determining whether these transactions had a valid business purpose, we consider whether appellant was engaged in a trade or business such that it was entitled to the claimed business expense deductions. A taxpayer is generally allowed to deduct business expenses under Internal Revenue Code (IRC) section 162 so long as the expenses are ordinary and necessary and paid or incurred during the tax year in carrying on any trade or business.[4] The business expense must be "directly connected with or pertaining to the taxpayer's trade or business[.]" (Treas. Reg. § 1.162-1(a).) Further, to be engaged in a trade or business, (1) the taxpayer's primary purpose for engaging in the activity must be for income or profit, (2) the taxpayer must be involved in the activity with continuity and regularity, and (3) the taxpayer's business operations must have actually commenced. (*Comm'r v. Groetzinger* (1987) 480 U.S. 23, 35; *Appeal of Hill* (81-SBE-049) 1981 WL 11777.)

Even if a taxpayer decided to enter into business and spent money in the preparation for entering that business, the taxpayer has not engaged in carrying on a trade or business until such time as the business functions as a going concern and performs the activities for which it was intended. (*Appeal of Hill, supra*.) A taxpayer may deduct as a business expense reasonable

[4] IRC section 162 is incorporated into California law by R&TC sections 17201 and 24343, except as otherwise provided.

compensation paid for personal services, such as management fees, so long as the services are "actually rendered" and the amount paid is "reasonable." (IRC, § 162(a)(1); see also *Elick v. Comm'r*, T.C. Memo. 2013-139; *International Capital Holding Corp. v. Comm'r*, T.C. Memo. 2002-109.) Appellant bears the burden of showing that it is entitled to the deduction. (*Appeal of Robinson*, 2018-OTA-059P.)

Here, appellant has not provided any evidence that it engaged in any trade or business. While appellant asserts that Mr. La Rosa intended to use appellant to engage in the cattle ranching business, appellant has not offered any evidence to substantiate that claim. There is no mention of cattle ranching in the Opinion Letter, dated November 2006. In addition, appellant's 2007 tax return shows no business activity, as appellant reported zero gross receipts and claimed no other expenses other than the $3,150,000 at issue. Moreover, appellant reported that its business activity was consulting services. Appellant also reported zero gross receipts on its 2008 tax return. There is no evidence in the record to support a finding that appellant operated a business that functioned as a going concern or performed the activities for which it was intended. In addition, appellant has not shown that La Rosa Management LLC provided any services to appellant to justify the fees paid. We follow the direction of the courts, which have disallowed the deduction where the taxpayer has not demonstrated that services were actually rendered. (*Elick v. Comm'r., supra,* T.C. Memo. 2013-139.) We find that appellant has not shown that it is entitled to the deductions for business expenses.

Further, Mr. La Rosa's actions contradict the stated business purpose of creating appellant to pursue new business ventures as Mr. La Rosa abandoned his purported interest in the cattle business shortly after forming appellant and executing the Service Agreement. Mr. La Rosa also remained employed at the logistics and freight companies. As for appellant's contention that the transactions had the business purpose of combining the funds of two existing trusts and avoiding estate tax, appellant has not shown how that purpose demonstrates a bona fide profit-seeking motive.

Moreover, the Opinion Letter shows that appellant was primarily interested in entering the transaction for tax avoidance motives. The Opinion Letter described the transactions as a way to facilitate Mr. La Rosa's desire to avoid estate taxes as well as create an income tax deduction. In the present appeal, the record shows that the purpose of appellant's incorporation was not to pursue business activity, but to avoid estate tax and create deductions for income tax

purposes. As discussed above, appellant has not shown that it conducted any business following its incorporation. Therefore, we find that appellant has not shown that the money-transferring transactions had valid nontax California business purposes.

Economic Substance Factor

The transactions that gave rise to the tax benefit was the formation of appellant and the Service Agreement between appellant and La Rosa Management LLC, which provided appellant with a current deduction that resulted in a flow-through loss to Mr. La Rosa to offset his earned income. Mr. La Rosa was the sole shareholder of appellant and the sole manager of La Rosa Management LLC. The $3,150,000 in payments made pursuant to the Service Agreement were reportedly estimates based on Mr. La Rosa's anticipated wages. Further, the fact that the fees were nonrefundable and payable prior to services being rendered supports the finding that there was no economic substance for the transaction. We find that appellant has not shown that the fees were paid for reasons other than merely to generate a flow-through tax benefit to Mr. La Rosa.

The record shows that appellant did not perform any business activity. Appellant has not shown that any services were provided to justify the payments. (See *Elick v. Comm'r*, *supra*, T.C. Memo. 2013-139.) Through appellant, La Rosa Management LLC, and the Service Agreement, the funds were ultimately transferred from the La Rosa Kids Trust 1 to the La Rosa Kids Trust 2 with no real economic substance. The bank records show little activity by appellant and La Rosa Management LLC apart from the transfer of $3,150,000 from appellant to La Rosa Management LLC to the La Rosa Kids Trust 2. Since appellant was not engaged in any business activity, appellant has not shown that the transfer of funds between related entities all controlled by Mr. La Rosa served the claimed purpose of insulating Mr. La Rosa or any other related entity from potential creditor claims. As further proof that this claim lacks merit, Mr. La Rosa also transferred a significant portion of those funds to his personal accounts.

Mr. La Rosa had primary control of the trusts, appellant and La Rosa Management LLC, and caused appellant to enter into these transactions to provide him with flow-through losses to offset his earned income. The evidence shows that appellant engaged in this transfer of money between entities all controlled by Mr. La Rosa solely to create tax benefits for Mr. La Rosa. (See *Merryman v. Comm'r* (5th Cir. 1989) 873 F.2d 879, 882.) The transactions were not capable of creating a profit or affecting appellant's economic situation, because appellant merely served as a

conduit for Mr. La Rosa to transfer funds from the La Rosa Kids Trust 1 to the La Rosa Kids Trust 2. At the end of the day, Mr. LaRosa created a $3,150,000 deduction for himself by contributing the same amount to his children's trusts and to himself using appellant and his management company. Accordingly, we find that appellant has not shown that its money-transferring activity and the Service Agreement had economic substance.

Appellant points out that respondent did not propose to assess additional tax in its NPA for 2007. Based on this fact, appellant argues that the plain language of R&TC section 19774 does not allow the imposition of the penalty if there is no additional tax assessed. Appellant contends that R&TC section 19774 expressly states that the penalty is "added to the tax" in an amount equal to 40 percent of the amount of the understatement. Appellant argues that because no additional tax was due, the NEST penalty may not be applied. Appellant asserts that there is no other reasonable interpretation of R&TC section 19774. We disagree.

Appellant erroneously interprets the term, "added to the tax," to mean added to the "additional tax." The statute does not refer to additional tax and appellant offers no authority, and we are aware of none, to support the contention that the penalty applies only if the taxpayer has a positive tax liability. The NEST penalty is imposed based on the amount of the understatement of taxable income, not the amount of additional tax assessed by respondent. R&TC section 19774(c)(1) incorporates the definition of "understatement" for reportable transactions provided by IRC section 6662A(b)(1)(A) as "an increase in taxable income," including any reduction of the excess of deductions allowed for the taxable year over gross income for such year multiplied by the highest rate of applicable tax. Here, appellant was not entitled to deduct the $3,150,000 in business expenses deductions and, as a result, appellant's taxable income increased by $3,150,000. The understatement is calculated as $47,250 (i.e., $3,150,000 x 1.5 percent tax rate for S corporations in California). (R&TC, §§ 19774(c)(1), 23802(b)(1); IRC, § 6662A(b)(1)(A).) The amount of the NEST penalty is calculated as $18,900 (i.e., $47,250 x 40 percent). Therefore, we find that respondent properly imposed the NEST penalty.

As for appellant's contention that the penalty should be abated for reasonable cause because it relied in good faith on the advice of counsel in entering into and reporting the transaction, there is no reasonable cause exception to the imposition of the NEST penalty.

Having found that the NEST penalty was properly imposed, only respondent's Chief Counsel may compromise it. (R&TC, § 19774(d).)

HOLDING

Appellant has not shown that the transactions had economic substance or a valid business purpose. Thus, respondent correctly determined that appellant is subject to the NEST penalty.

DISPOSITION

Respondent's action is sustained in full.

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John O Johnson
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John O. Johnson
Administrative Law Judge

We concur:

DocuSigned by:
Tommy Leung
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Tommy Leung
Administrative Law Judge

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