OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **ROBERT W. HENSE AND PAMELA M. HENSE**	) OTA Case No. 18073409)

OPINION

Representing the Parties:

For Appellants: Jeffrey S. Jacobs, Attorney at Law

For Respondent: David Kowalczyk, Tax Counsel
Marguerite Mosnier, Tax Counsel IV

S. HOSEY, Administrative Law Judge: Pursuant to California Revenue and Taxation Code (R&TC) section 19324, Robert W. Hense and Pamela M. Hense (appellants) appeal an action by respondent Franchise Tax Board (FTB) denying appellants' claim for refund of $20,045.25 for the 2014 tax year.

Office of Tax Appeals Administrative Law Judges Sara A. Hosey, Daniel K. Cho, and Richard I. Tay, held an oral hearing for this matter in Los Angeles, California, on July 23, 2019. At the conclusion of the hearing, the record was kept open to allow additional post-hearing briefing and this matter was submitted for decision on October 16, 2019.

ISSUE

Are appellants liable for the notice and demand penalty (demand penalty) imposed under R&TC section 19133?

FACTUAL FINDINGS

1. On January 22, 2016, FTB issued to appellants a Demand for Tax Return (Demand) because its records indicated that appellants' 2014 California resident income tax return had not been filed and they had received sufficient income to trigger a filing obligation. The Demand required appellants to respond by a certain date, by either filing a 2014 tax

return, sending a copy of the return if one had been filed, or explaining why they were not required to file a return. Appellants did not respond.

2. Subsequently, FTB issued a Notice of Proposed Assessment (NPA) on March 21, 2016, which proposed to assess tax—based on income reported by third-party sources—and, among other things, the demand penalty. Appellants did not protest the NPA and the assessment became final on June 13, 2016.
3. Appellants ultimately filed their joint 2014 California Nonresident income tax return. Appellants reported a total tax liability of $80,181.00 and withholding of $88,139.00 for an overpayment/refund amount of $7,958.00. FTB accepted the return.
4. After processing appellants' 2014 tax return, FTB issued a Notice of Tax Return Change, reducing the originally-assessed demand penalty to $20,045.25 and removing the other penalty and fee. Appellants paid it.
5. Appellants filed a claim for refund, requesting the demand penalty be abated based on reasonable cause grounds.
6. FTB denied the refund claim, asserting appellants did not establish reasonable cause for abatement. This timely appeal followed.
7. As relevant here, FTB had previously issued an NPA dated June 22, 2015, for appellants' failure to file a 2013 tax return. This NPA was issued after appellants did not respond to FTB's Request for Tax Return (Request) dated April 22, 2015, for their 2013 tax return.

DISCUSSION

R&TC section 19133 provides that if a taxpayer fails to file a return upon notice and demand by FTB, then FTB may impose a penalty of 25 percent of the amount of tax assessed pursuant to R&TC section 19087, unless the failure is due to reasonable cause and not willful neglect. California Code of Regulations, title 18, (Regulation) section 19133 further provides that for individuals, the demand penalty will only be imposed if the following two conditions are satisfied:

> (1) the taxpayer fails to timely respond to a current Demand for Tax Return in the manner prescribed, and
>
> (2) the FTB has proposed an assessment of tax under the authority of Revenue and Taxation Code section 19087, subdivision (a), after the taxpayer failed to timely respond to a Request for Tax Return or a Demand for Tax Return in the

> manner prescribed, at any time *during the four-taxable-year period preceding the taxable year for which the current Demand for Tax Return is issued*.

(Cal. Code Regs., tit. 18, § 19133(b)(1)-(2), emphasis added.)

Under the plain and unambiguous language of subsection (b)(2) above, we find, contrary to FTB's interpretation and application to the facts here, that this subsection requires the NPA for a prior tax year to have been issued at any time "*during* the four-taxable-year period preceding" the current tax year for which FTB seeks to impose the demand penalty. Here, to properly impose the demand penalty for the 2014 tax year, FTB's regulation requires that FTB have issued an NPA for a prior tax year on a date anytime between January 1, 2010, through December 31, 2013. This threshold requirement has not been met in this case.

Specifically, rather than being issued "during the four-taxable-year period *preceding* the taxable year for which the current [Demand] is issued," FTB's NPA for the 2013 tax year was not issued until June 22, 2015, which is *after* the 2014 tax year "for which the current [Demand] is issued." (Emphasis added.) Therefore, FTB improperly imposed the demand penalty.

We also note that Example 2 of the regulation appears to apply the regulation as if it stated that the demand penalty could be issued if an NPA were issued "within the previous four years." On this ground, the example contemplates imposition of the demand penalty for the 2001 tax year where the prior NPA for the 1999 tax year was issued on a date during the 2001 tax year. Thus, the example imposes the demand penalty when the prior NPA was issued during the *same* tax year for which the current Demand is issued.

However, this example is directly contrary to the operative language of the regulation that requires that the prior NPA have been issued "during the four-taxable-year period *preceding* the taxable year for which the current [Demand] is issued." (Emphasis added.) Thus, FTB's regulation is internally inconsistent. Furthermore, as stated in Regulation section 19133(d), the examples are only "intended to illustrate the provisions of this regulation." It has been stated that "examples set forth in regulations remain persuasive authority *so long as they do not conflict with the regulations themselves*." (*Cook v. Commissioner* (7th Cir. 2001) 269 F.3d 854, 858, emphasis added.) This suggests that conflicts between regulatory language and illustrative examples should be resolved in favor of the regulatory language. We agree.

We find the operative language of the regulation is unambiguous. It carefully and precisely references "the four-taxable-year period preceding" the tax year for which the current

Demand is issued. Rather than interpreting the operative language of the regulation, the example appears to overlook or disregard that language. In this circumstance, we see no reason to place greater weight on the implication of the example than on the clear and precise operative language. We therefore resolve the internal conflict in FTB's regulation by finding that FTB is bound by the ordinary and unambiguous meaning of the words used in the governing language of its regulation. Here, as FTB did not properly impose the demand penalty pursuant to Regulation section 19133(b)(2), appellants are not liable for it for the 2014 tax year.

HOLDING

Appellants are not liable for the demand penalty.

DISPOSITION

FTB's action is reversed, and appellants are due a refund of $20,045.25, plus applicable interest.

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Sara A Hosey
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Sara A. Hosey
Administrative Law Judge

I concur:

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Daniel Cho
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Daniel K. Cho
Administrative Law Judge

R. TAY, dissenting:

I respectfully dissent from the majority's holding regarding FTB's assessment of the demand penalty for the 2014 tax year. I believe the plain language of California Code of Regulations, title 18, (Regulation) section 19133, in its entirety, is *not* clear, and applying the rule in subsection (b) alone results in absurd consequences that FTB did not intend. Thus, rather than "resolve the internal conflict" by disregarding subsection (d), I respectfully believe we should defer to FTB's interpretation and uphold its demand penalty assessment.

A plain reading of Regulation section 19133 reveals the ambiguity in how to apply the demand penalty. As stated in the majority opinion, the rule in subsection (b)(2) conflicts with subsection (d), Example 2, of the regulation. This kind of contradiction is a prime example of what is, unfortunately, "a familiar problem in administrative law: . . . regulations may be genuinely ambiguous." (*Kisor v. Wilkie* (2019) 139 S. Ct. 2400, 2410, 204 L. Ed. 2d 841.) Indeed, the court said, "[s]ometimes, this sort of ambiguity arises from careless drafting—the use of a dangling modifier, an awkward word, an opaque construction." (*Id.* at p. 2410.) When faced with such "opaque construction," which results in ambiguous regulatory language, courts have held that "a court should defer to the agency's construction of its own regulation." (*Id.* at pp. 2410-2411.) Yet, instead of deferring to FTB's interpretation in the face of the apparent contradiction, the majority here applies the rule in subsection (b) because it does not want to "place greater weight" on the example in subsection (d).

However, the primary issue here is not how to weigh subsection (b) and subsection (d). The first issue is more basic – is Regulation section 19133 clear in its application or genuinely ambiguous? To answer that question, courts have held that "we must follow the fundamental rule of statutory construction that requires every part of a statute be presumed to have some effect and not be treated as meaningless unless absolutely necessary." (*People v. Arias* (2008) 45 Cal.4th 169, 180; see also *Delaney v. Superior Court* (1990) 50 Cal.3d 785.) Every word, phrase, sentence, and part of a regulation should be given significant consideration in discerning its purpose. (*Curle v. Superior Court* (2001) 24 Cal.4th 1057, 1063.) However, that language is not examined in isolation, "but in the context of the regulatory framework *as a whole*" to determine the scope and purpose of the regulation and to harmonize its various parts. (*Sierra Club v. Superior Court* (2013) 57 Cal.4th 157, 165, italics added.) "If the language is clear,

courts must generally follow its plain meaning unless a literal interpretation would result in absurd consequences the [administrative agency] did not intend." (*Id*. at pp. 164-165.)

Following these rules of statutory construction, I believe, a plain reading of Regulation section 19133 leads to two possible applications – that which is contained in subsection (b) and the application contained in subsection (d). If "interpreting the regulation involves a choice between (or among) more than one reasonable reading," the regulation is genuinely ambiguous. (*Kisor v. Wilkie*, *supra*, 139 S.Ct. at p. 2411.) Thus, I find that Regulation section 19133 is genuinely ambiguous.

The majority cites the Seventh Circuit opinion, *Cook v. Commissioner* (7th Cir. 2001) 269 F.3d 854 (*Cook*), as authority to invalidate subsection (d); however, I find the majority's application inapposite here. In *Cook*, the court stated, "examples set forth in regulations remain persuasive authority so long as they do not conflict with the regulations themselves," which affirms a regulatory example's authority if the example does not conflict with the rest of the regulation. However, the court gives no interpretive or applicational guidance when examples *do* conflict with the rest of the regulation, as is the case here. Whether subsection (d) is persuasive authority is neither here nor there. Regardless of its authoritative weight, this panel should consider the example in determining whether the regulation is genuinely ambiguous.

Courts have regularly examined the plain language of examples to determine whether an ambiguity in a regulation or statute exists. In *Household Credit Services, Inc. v. Pfennig* (2004) 541 U.S. 232, the court, in analyzing title 15 United States Code section 1605(a), notably overturned the lower court's decision because "the Court of Appeals had failed to examine . . . the surrounding language in § 1605," and specifically, the Court of Appeals did not consider the fact that "none of § 1605's specific examples" provided clarity. Only after examining "the full text of § 1605" did the court conclude that the statute was indeed ambiguous. (*Id.* at p. 241.)

Additionally, the Ninth Circuit Court of Appeals carefully examined the language of an example found in Treasury Regulation section 31.3505-1(b)(2) to support its conclusion that the regulation was ambiguous. (*United States v. Metro Construction Co., Inc*. (9th Cir. 1979) 602 F.2d 879.) This holding was followed by the Sixth Circuit, which held that "the regulation, in the light of the illustration, is ambiguous." (*U.S. v. Intercontinental Industries, Inc.* (6th Cir. 1980) 635 F.2d 1215, 1222.) The courts' practice of examining every word of the regulation,

including the examples, to discern its meaning and application is well-established.[1] As such, I believe that every word of Regulation section 19133, including its illustrative provisions, should be carefully examined to discern the regulation's meaning.

Additionally, FTB drafted the regulation, including subsection (d), and passed it through the regulatory process set forth by the Administrative Procedures Act. The "plain language" of the regulation includes subsection (d) as much as it does subsection (b). Thus, subsection (d) should be treated as an integral part of the regulation, and in so doing, I find that the regulation is genuinely ambiguous.

Although Regulation section 19133 is genuinely ambiguous, FTB's interpretation must still pass muster for this panel to defer. Even if a statute (or regulation) is ambiguous, agencies are not automatically given deference as to their interpretation. Indeed, courts have been loath to give agencies deference for interpretations that are unreasonable; to be given deference, an agency's interpretation must be authoritative or official, must implicate the agency's expertise, and must reflect "fair and considered judgment." (*Kisor v. Wilkie, supra*, 139 S.Ct. at p. 2417.) I find FTB's interpretation meets all these requirements and would lead to a result consistent with FTB's regulatory intent.

Conversely, applying the rule in subsection (b) is not consistent with FTB's regulatory intent because it fails to properly account for the taxpayer's prior four-year filing history and leads to an absurd result. The rulemaking materials and the language of Regulation section 19133 indicate that FTB's intent was to limit application of the demand penalty to repeat non-filers – those who had not filed a tax return twice in a four-year period. By requiring only that FTB issue the requisite NPA *during* the prior four years, that NPA could conceivably be issued *for* any tax year open to assessment. The absurdity of this interpretation is best demonstrated where no return is filed. In this situation, there would be no time limit for FTB to issue the requisite NPA, per R&TC section 19057, and thus, where the taxpayer fails to file a return, FTB could have issued the requisite NPA for a tax year decades past, so long as it was issued *during* one of the four prior taxable years. The four-year lookback period for evaluating whether a taxpayer was a repeat non-filer, as originally contemplated by FTB, is effectively

[1] See also *Christopher v. SmithKline Beecham Corp*. (9th Cir. 2011) 635 F.3d 383; *Marsh v. J. Alexander's LLC* (9th Cir. 2018) 905 F.3d 610; *Major v. Silna* (2005) 134 Cal.App.4th 1485; *People v. Arias*, *supra*.

eliminated. Contrary to the stated purpose of Regulation section 19133, taxpayers who previously made timely returns for the prior four years would be subject to the demand penalty.

Thus, I respectfully dissent from the majority's holding regarding FTB's assessment of the demand penalty for appellants' 2014 tax year. The language of Regulation section 19133 is genuinely ambiguous, and FTB's interpretation of the regulation is reasonable and comports with the intent of the regulation. I believe this panel should give FTB deference, and I would sustain FTB's assessment.

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Richard I. Tay
Administrative Law Judge

Date Issued: 1/24/2020