

2. Whether FTB properly imposed the noneconomic substance transaction understatement (NEST) penalty under R&TC section 19774.
3. Whether FTB properly imposed the interest-based (IB) penalty under R&TC section 19777.
4. Whether appellants have shown a basis to abate accrued interest.

FACTUAL FINDINGS

General Background

1. According to appellants, they engaged “RS” to prepare their tax returns.² RS recommended that appellants “invest” in various limited liability companies (LLCs), including Blackbriar Investments LLC (collectively, the “Blackbriar-like Entities”), and advised appellants that they could then claim losses from these LLCs on their tax returns.
2. On June 5, 2008, appellants filed a 2007 joint California income tax return. On the return, appellants claimed \$139,900 in losses related to purported investments in one or more of the Blackbriar-like Entities.
3. On April 11, 2011, appellant-wife contacted the police regarding RS. The police report provided by appellants states in pertinent part:

On approximately 04/19/10, [appellants] received a notice form [sic] the State of California, Franchise Tax Board telling them that they may have understated their personal income tax liability for 2006 and 2008. Specifically they claimed deductions for losses from one of several LLC’s [sic] The Tax Board stated that the entities listed never existed and therefore never sustained the losses [appellants] claimed. [Appellant-wife] said she had no knowledge of such LLC’s [sic]. She said they only provided [RS] with the employer provided W2’s, whatever tax statements the mortgage company sent, and tax forms provided by the personal investments companies. [Appellant-wife] said they are not involved in any sort of companies other than [their] primary employment.

The police report further indicated that on approximately January 13, 2011, appellants also received a notice from the Internal Revenue Service (IRS) reflecting additional tax and penalties totaling more than \$95,000 for 2007 through 2009. The report stated that appellant-wife provided copies of the letters received from both FTB

² Appellants’ tax advisor is not a party to the appeal and therefore will be referred to simply as “RS.”

and the IRS to the reporting officer and that these letters were attached along with the police report.

4. According to newspaper reports, during April 2012, RS was taken into federal custody in connection with the preparation of fraudulent tax returns, and, in July 2013, RS pled guilty to three counts of aiding and assisting in the preparation of fraudulent tax returns.

FTB Examination and Demands for Information

5. On April 19, 2010, FTB sent appellant-husband a self-compliance letter stating that it had obtained information indicating that appellants may have understated their income tax liability for certain tax years.³ FTB further stated that the information it obtained indicated that appellants may have claimed deductions for losses from one of the Blackbriar-like Entities. FTB stated that the Blackbriar-like Entities never existed, never filed tax returns, and never sustained the losses reported on appellants' tax returns. FTB further stated that appellants' interest in the Blackbriar-like Entities appeared to have been artificially created for the sole purpose of passing fictitious losses that were then claimed on appellants' tax return

In the letter, FTB noted that the R&TC provides for the imposition of a NEST penalty, an IB penalty, and an accuracy-related penalty, and FTB stated that it believed the penalties may be applicable.

The FTB provided appellants two options in this letter. The first option allowed appellants to file amended tax returns to eliminate all artificial deductions for "all years" for which they reported losses from the Blackbriar-like Entities, and pay all tax and interest, plus a 20 percent accuracy-related penalty under R&TC section 19164 (or request an installment payment arrangement).

The second option was to proceed with the examination, in which case appellants were requested to provide a copy of their California and federal tax returns for 2007 and additional evidence and information, including information regarding the Blackbriar-like Entities. FTB stated that, if the second option was selected, and FTB determined that additional tax was due, it would impose "the maximum applicable penalties allowed

³ The letter specifically lists the 2006 and 2008 tax years in the heading but indicates that the letter applies to all tax years from 2003-2009 if appellants claimed deductions for losses from the Blackbriar-like Entities. The letter also requested information relating to the 2007 tax year, including appellants' tax return for 2007, if appellants selected the second option provided in the letter.

- under California law,” including the 40 percent NEST penalty and the 100 percent IB penalty. FTB requested a response by May 11, 2010.
6. Appellants did not respond to the April 19, 2010 letter.
 7. On July 12, 2010, FTB sent appellant-husband a follow-up letter, which stated that its records did not show any response to its April 19, 2010 letter. FTB provided additional time to respond, setting a deadline of July 23, 2010. FTB also stated that, if it did not receive the requested information, it may assess a penalty of 25 percent of the additional tax for the failure to provide the requested information under R&TC section 19133.
 8. Appellants did not respond to the July 12, 2010 letter.
 9. On November 2, 2010, FTB issued a “formal, legal demand” to appellants for the information FTB previously requested in its letters dated April 19, 2010, and July 12, 2010, and attached copies of these letters. FTB provided an additional extension of time, to November 19, 2010, for appellants to provide the requested information. The letter referenced tax years 2006 through 2009, and provided the proposed tax, penalties, and interest for each year if FTB did not receive the requested information. For the 2007 tax year, FTB indicated that would propose disallowing \$139,900 in losses from the Blackbriar-like Entities, which would result in additional tax of \$13,378. FTB also stated that it would propose a penalty for failure to furnish information, an IB penalty, and a NEST penalty.
 10. Appellants did not respond to the November 2, 2010 demand letter.
 11. By letter dated September 1, 2011, FTB informed appellants that recent legislation had enacted Voluntary Compliance Initiative 2 (VCI2).⁴ In the letter FTB explained that the VCI2 program allowed taxpayers a limited opportunity to amend their tax returns and obtain a waiver of the accuracy-related penalty. FTB stated that, if appellants wished to amend their tax returns without incurring penalties, FTB’s representative could prepare the tax returns for them. FTB requested that appellants contact it by September 23, 2011, and stated that, if appellants did not contact FTB by that date, FTB would close the case with the imposition of penalties.

⁴ See R&TC section 19761, which provided a voluntary compliance initiative for abusive tax avoidance transactions and unreported income from the use of offshore financial arrangements.

12. On September 9, 2011, appellant-wife called FTB to discuss a notice that appellants had received. Appellant-wife stated that their tax representative had prepared amended tax returns. However, FTB informed appellant-wife that it had not received any amended returns or other information from appellants' tax representative. FTB asked appellant-wife to have their tax representative contact it and explained that it needed to determine the tax liability before an installment plan could be completed. Appellant-wife agreed to have their tax representative contact FTB.
13. By letter dated October 21, 2011, FTB again invited appellants to participate in the VCI2 program by amending their tax returns, filing a VCI2 Participation Agreement, and paying all tax and interest (or entering into an installment agreement). FTB noted that the deadline for participation was October 31, 2011.
14. On December 2, 2011, FTB sent appellants a second demand letter. FTB stated that on September 9, 2011, appellants had informed it that their tax preparer would be filing amended tax returns for the 2006 through 2009 tax years, but that FTB had received no amended tax returns or other communications from the preparer. FTB further stated that it had not received responses to its letters dated April 19, 2010, July 12, 2010, and November 2, 2010, and attached copies of those letters. FTB stated, "**This is a FINAL formal, legal demand for the information requested.**" (Emphasis in original.) FTB set a deadline of December 21, 2011, for appellants to provide the requested information.
15. On December 27, 2011, appellant-wife again called FTB and indicated that appellants wished to resolve the matter. FTB stated that it could prepare amended tax returns for the 2006 through 2009 tax years eliminating the losses from the Blackbriar-like Entities and imposing an accuracy-related penalty, which appellants could then file with FTB. According to FTB's call log, appellant-wife stated that appellants were never involved with any partnerships, were married and only had mortgage interest, and that they simply gave their information to their tax preparer (evidently referring to RS). FTB's auditor stated that the amended returns would be sent to appellants by the end of the week.
16. On this same day, FTB prepared amended returns and sent them to appellants for their approval and signature. A cover letter dated December 27, 2011, sent with the amended

returns, requested that appellants return the signed and completed returns by January 21, 2012.⁵

17. Appellants did not sign and return the amended returns to FTB.
18. By letter dated February 6, 2012, FTB issued another “**final formal, legal demand for the information requested**” for the 2006 through 2009 tax years. (Emphasis in original.) FTB noted that it had not received a response to its December 27, 2011 letter or any amended tax returns and attached a copy of that letter, the amended returns for 2006 through 2009, and its previous demand letter dated December 2, 2011. FTB set a deadline of February 20, 2012, for the information to be provided and stated that, if the information was not provided, it would issue a proposed assessment including additional penalties.
19. Appellants did not respond to the February 6, 2012 demand letter.
20. Each of FTB’s letters were sent to the same street address, which is the address appellants continue to use in this appeal. Appellants also listed this address on their 2009 tax return dated March 15, 2010, which was the most recent California income tax return filed by appellants prior to the letters FTB sent regarding the 2007 tax year.

Proposed Assessments, Refund Claim, and Appeal

21. On May 26, 2010, FTB issued a Notice of Proposed Assessment (NPA) for the 2007 tax year. The NPA proposed to disallow a capital loss of \$4,361 and reflected accrued interest. It did not propose any penalties. Appellants did not protest the NPA and it became final.
22. On November 28, 2012, FTB issued a second NPA for the 2007 tax year, proposing to disallow \$139,900 in deductions related to the Blackbriar-like Entities. FTB proposed additional tax of \$13,378.00, a \$3,344.50 failure to furnish information penalty, a \$3,109.91 IB penalty, and a \$5,254.95 NEST penalty. Appellants did not protest the NPA, so this NPA also became final.
23. In a letter dated May 20, 2016, appellants requested that FTB abate the penalties and interest for the 2007, 2008, and 2009 tax years.

⁵ Appellants were instructed to carefully review the amended returns for accuracy, and if they agreed, complete the tax returns by inputting their social security numbers, signing, and dating the returns.

24. On July 28, 2016, appellants' liability for tax, penalties, and interest for the 2007 tax year was fully satisfied through wage garnishment.
25. On November 16, 2016, FTB issued a Notice of Action (NOA), treating appellants' May 20, 2016 letter as a claim for refund of \$11,709.36 for the 2007 tax year and denying the claim for refund.⁶
26. Appellants timely appealed the NOA to the Board of Equalization (BOE).⁷ On February 24, 2017, BOE informed appellants that it had accepted their appeal for the 2007 tax year only.⁸
27. During the pendency of this appeal, appellants requested that FTB's Chief Counsel relieve the NEST penalty. The appeal was deferred while that request was considered. FTB's Chief Counsel subsequently reduced the amount of the NEST penalty imposed for 2007 by 50 percent, from \$5,254.95 to \$2,627.47.

DISCUSSION

Issue 1 - Whether FTB properly imposed a penalty under R&TC section 19133 for failure to furnish information.

R&TC section 19133 provides that 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 and not willful neglect, FTB may add a penalty of 25 percent of the amount of tax determined pursuant to R&TC

⁶ It appears FTB treated appellants' letter as a protective claim for refund that was later perfected when FTB collected the full amount due for the 2007 tax year through wage garnishment. Unlike appellants' liabilities for the 2007 tax year, their liabilities for the 2008 and 2009 tax years had not been paid in full. Consequently, FTB did not treat appellants' May 20, 2016 correspondence as perfected claims for refund for those years. It therefore issued a separate letter for the 2008 and 2009 tax years that denied the request for abatement but did not provide appeal rights.

⁷ BOE is the predecessor of the Office of Tax Appeals with respect to franchise and income tax and business tax appeals.

⁸ BOE informed appellants that it could not include the 2008 and 2009 tax years in this appeal because a balance due remained, FTB had not issued a Notice of Action or Denial of Claim for Refund, and BOE therefore lacked jurisdiction for those years. As a result, only the 2007 tax year is before us in this appeal.

section 19087 or of any deficiency assessed.⁹

In their opening brief, appellants contend that FTB “never demanded any information from [them].” Additionally, after receiving FTB’s opening brief, which provided copies of the correspondence FTB sent to them, appellants claim that they do not recall receiving and, after searching their records, could not locate copies of FTB’s letters dated April 19, 2010, September 1, 2011,¹⁰ October 21, 2011, December 2, 2011, and February 6, 2012. Appellants are silent as to whether they recall receiving or can locate copies of FTB’s letters dated July 12, 2010, and November 2, 2010. Appellants only affirmatively acknowledge receiving a single letter from FTB: FTB’s letter dated December 27, 2011.

We find this implausible. All the letters were sent to the same address at which appellants received other correspondence.¹¹ Moreover, while appellants contend that they do not recall receiving and cannot locate a copy of FTB’s letter dated April 19, 2010, appellants clearly did receive and have a copy of this letter, as appellant-wife provided a copy of it to the Irvine Police Department when appellant-wife filed a police report with it on April 11, 2011.¹² Additionally, appellant-wife’s two separate telephone calls to the auditor handling appellants’ FTB audit examination on September 9, 2011, and December 27, 2011, further calls into question appellants’ lack of recollection or record of FTB’s audit correspondence sent to them prior to these dates. Even if it were true that appellants do not recall receiving and cannot locate copies of FTB’s demand letters, the record shows that FTB repeatedly sent appellants letters demanding information.¹³ If appellants did not take notice of the letters, that only illustrates that appellants failed to exercise ordinary diligence and care.

The record shows that FTB properly mailed its demand letters to appellants’ last-known

⁹ See also California Code Regulations, title 18, section 19032(b)(5)(C)(2), which expressly notes that a penalty may be imposed as provided in R&TC section 19133 where the taxpayer fails to furnish information during an audit after formal notice and demand by the auditor.

¹⁰ Appellants listed a date of September 9, 2011, for this letter, but this appears to be a typographical error because the exhibit they reference contains FTB’s letter dated September 1, 2011.

¹¹ This includes but is not limited to: FTB’s letter dated December 27, 2011, which appellants acknowledge receiving; the two NPAs dated May 26, 2010, and November 28, 2012; the NOA dated May 20, 2016; and the correspondence related to this appeal.

¹² The police report specifically references this letter and states that both this letter and an IRS notice were provided and attached to the police report.

¹³ FTB demanded that appellants furnish information for the 2007 tax year at least three times in its letters dated November 2, 2010, December 2, 2011, and February 6, 2012.

address (as reflected on appellants' 2009 California tax return, dated March 15, 2010), which remains appellants' current address as of this appeal. It is well settled that any notice to the taxpayer shall be sufficient if it is mailed to the taxpayer's last-known address, which is the address that appears on the taxpayer's last return filed with FTB, unless the taxpayer has provided to FTB clear and concise written or electronic notification of a different address, or FTB has an address it has reason to believe is the most current address for the taxpayer. (R&TC, § 18416(b) & (c).) This is true even where the taxpayer claims never to have received the notice. (*Appeal of Goodwin* (97-SBE-003) 1997 WL 258474.)

Appellants also assert that they mailed FTB a form, on which they indicated they would file amended returns, in response to FTB's letter dated December 27, 2011. However, FTB has no record of receiving any such response, and appellants have not provided any proof of mailing.¹⁴ We do not find appellants' claim credible. Moreover, even if we assume for purposes of our analysis that appellants mailed such a response, they never filed the amended tax returns, even though FTB sent them a letter on February 6, 2012, noting that it had not received any amended returns and once again demanded information from appellants. As noted above, appellants did not provide any information or otherwise respond to FTB's February 6, 2012 demand.

In support of their argument that they expected that their tax preparer would file amended tax returns, appellants provide an invoice from their tax preparer, which they quote as stating it was for "the preparation of federal and state individual income tax returns." However, the quote provided by appellants omits language from the invoice, which states that it is a billing for the "the preparation of federal and state individual income tax returns *for the year ended December 31, 2010.*" (Emphasis added.) The invoice does not reference the filing of any amended tax returns and appears to be unrelated to the 2007 tax year at issue in this appeal.

Appellants also contend that they relied on their advisor, RS, who they allege "duped" them. They further contend they acted in good faith and have good tax compliance history. These arguments relate to the filing of their original tax returns as prepared by RS reporting losses from the Blackbriar-like Entities. These arguments do not provide a reasonable explanation for why appellants subsequently failed to provide the information demanded by FTB

¹⁴ FTB specifically noted and informed appellants that it had not received a response to its letter dated December 27, 2011, in its subsequent demand letter dated February 6, 2012.

during the audit examination, and therefore, fail to establish reasonable cause for appellants' failure to respond to FTB's demands for information.

In sum, FTB properly imposed the penalty for failure to furnish information, and appellants have not shown any basis to abate the penalty.

Issue 2 - Whether FTB properly imposed the NEST penalty under R&TC section 19774.

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.” The penalty is reduced to 20 percent with respect to the portion of any NEST understatement if 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).)

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).)

Once the NEST penalty is imposed and the NPA has been issued, only FTB's Chief Counsel “may compromise all or any portion of that penalty.” (R&TC, § 19774(d)(1).) As noted above, FTB's Chief Counsel exercised discretion to reduce the NEST penalty by 50 percent. Thus, FTB's Chief Counsel reduced the penalty from the original amount of 40 percent of the understatement to 20 percent of the understatement. “Notwithstanding any other law or rule of law,” any NEST penalty determination by FTB'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 compromising the remaining 20 percent NEST penalty or reviewing the decision of FTB's Chief Counsel not to compromise or abate the NEST penalty in its entirety, our limited role does allow us to determine whether the penalty was properly imposed in the first place.

When FTB imposes a penalty, the law presumes that FTB properly imposed the penalty. (*Appeal of Xie*, 2018-OTA-076P.) Appellants have the burden of showing error in FTB's imposition of the penalty. (*Ibid.*) Here, appellants do not contend, and there is nothing in the record to show, that appellants' reported investments in the Blackbriar-like Entities or the

disallowed losses had economic substance. Moreover, appellants appear to acknowledge and concede that the Blackbriar-like Entities were shams. According to the police report, appellant-wife told the reporting officer that appellants “had no knowledge of such LLC’s [sic],” and that “they are not involved in any sort of companies other than [their] primary employment.” On appeal, appellants explain that they chose not to protest the NPA because they “had discovered that [they] had been victims of a fraud perpetrated by [RS] ... and that therefore [they] actually were not entitled to take the aforementioned expenses and deductions on [their] tax return as [RS] had erroneously and fraudulently advised [them]” Appellants also acknowledge that they did not pay anything for the claimed investments in the Blackbriar-like Entities, stating instead that these “investments” were “being included in and at no additional cost to [them other] than [their] fee for the preparation of [their] tax returns.” Accordingly, appellants have not shown error in FTB’s determination that the Blackbriar-like Entities and the disallowed losses therefrom lacked economic substance or that FTB’s imposition of the NEST penalty was improper.

As noted above, appellants also contend that they relied on their advisor, RS, who they contend “duped” them. They further contend they acted in good faith and have good tax compliance history. However, R&TC section 19774 does not provide an exception to the imposition of the penalty for reasonable cause or other similar grounds.¹⁵

Finally, because FTB collected the full amount of the 40 percent NEST penalty through wage garnishment prior to the decision of FTB’s Chief Counsel to reduce the penalty by 50 percent, appellants are entitled to a refund of the 50 percent of the penalty that FTB’s Chief Counsel subsequently compromised.

Issue 3 - Whether FTB properly imposed the IB penalty under R&TC section 19777.

R&TC section 19777(a) provides that, if a taxpayer has been contacted by FTB regarding an abusive tax avoidance transaction, and has a deficiency attributable to an abusive tax avoidance transaction, FTB will impose a penalty equal to 100 percent of the interest payable pursuant to R&TC section 19101 for the period beginning on the due date of the payment of the tax and ending on the date the NPA is mailed. An “abusive tax avoidance transaction” includes any transaction to which R&TC section 19774 (i.e., the NEST penalty) applies. (R&TC,

¹⁵ Appellants cite Internal Revenue Code section 6664(c), but that provision relates to the accuracy-related penalty, which was not imposed by FTB.

§ 19777(b)(5).)

As discussed above in Issue 2, the NEST penalty under R&TC section 19774 applies here. Therefore, the transaction is an abusive tax avoidance transaction for purposes of the IB penalty. Also, FTB contacted appellants about the abusive tax avoidance transaction and notified them that the IB penalty would be imposed unless, among other things, they filed an amended tax return removing the sham deductions. Accordingly, FTB properly imposed the IB penalty.

R&TC section 19777 does not allow the IB penalty to be abated based on reasonable cause or other similar grounds. Thus, even accepting appellants' arguments that they acted reasonably and in good faith, such arguments do not provide a basis to abate the penalty.¹⁶

Issue 4 - Whether appellants have shown a basis to abate accrued interest.

R&TC section 19101 imposes interest on unpaid tax and penalties. Interest is not a penalty but is merely compensation for the taxpayer's use of money after it should have been paid to the state. (*Appeal of Gorin*, 2020-OTA-018P.) There is no reasonable cause exception to the imposition of interest. (*Ibid.*) To obtain relief from interest, a taxpayer must qualify under one of the waiver provisions of R&TC sections 19104, 19112, or 21012. (*Appeal of Balch*, 2018-OTA-159P.)

Pursuant to R&TC section 19104, FTB is authorized to abate or refund interest if there has been an unreasonable error or delay in the performance of a ministerial or managerial act by an employee of FTB. Here, appellants do not assert any such errors or delays occurred. Moreover, appellants significantly contributed to the time necessary for this matter to be resolved by failing to timely respond to FTB demands for information. We also note that relief pursuant to R&TC section 21012 is not relevant here, because FTB did not provide appellants with any written advice. Neither is relief pursuant to R&TC section 19112 relevant here, because appellants do not allege extreme financial hardship caused by significant disability or other catastrophic circumstance. Thus, appellants have not established any basis for abatement of

¹⁶ The subsequent reduction to the NEST penalty should not impact the computation of the IB penalty because the IB penalty is computed as 100 percent of the interest payable for the period beginning on the due date of payment of tax and ending on the date the NPA is mailed. (R&TC, § 19777(a).) Interest is only imposed on penalties, such as the NEST penalty, if not paid within 15 days of notice and demand therefor and then only for the period from the date of such notice and demand to the date of payment. (R&TC, § 19101(c)(2)(A).) A notice and demand for the NEST penalty would not occur until after the NPA assessing the NEST penalty has been issued and becomes final. Therefore, the NEST penalty did not factor into the computation of the IB penalty.

interest.

However, as previously noted, after FTB collected the amounts assessed, including interest, through wage garnishments, FTB's Chief Counsel reduced the NEST penalty by 50 percent. As a result, FTB must refund interest paid to the extent it reflects interest accrued on 50 percent of the NEST penalty subsequently compromised by FTB's Chief Counsel.

HOLDINGS

1. FTB properly imposed a penalty under R&TC section 19133 for failure to furnish information.
2. FTB properly imposed the NEST penalty under R&TC section 19774, which FTB's Chief Counsel subsequently reduced by 50 percent.
3. FTB properly imposed the IB penalty under R&TC section 19777.
4. Appellants have not shown a basis to abate accrued interest, but no interest should be imposed on 50 percent of the NEST penalty, which FTB's Chief Counsel removed.

DISPOSITION

FTB's action denying appellants' refund claim for the 2007 tax year is modified to allow a refund of 50 percent of the NEST penalty that FTB's Chief Counsel compromised and any interest paid by appellants that reflects interest accrued on the compromised portion of the NEST penalty. FTB's action is otherwise sustained.

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Cheryl L. Akin

Administrative Law Judge

We concur:

DocuSigned by:



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Sheriene Anne Ridenour

Administrative Law Judge

DocuSigned by:



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Teresa A. Stanley

Administrative Law Judge

Date Issued: 10/5/2020