2021 – OTA – 083
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **R. BURTON AND** **C. BURTON**	OTA Case No. 19054800

OPINION

Representing the Parties:

For Appellants: Kim D. Paskal, CPA

For Respondent: Leoangelo C. Cristobal, Tax Counsel

J. MARGOLIS, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19324, R. Burton and C. Burton (appellants) appeal an action by respondent Franchise Tax Board (FTB) denying appellants' $25,431.80 claim for refund for the 2017 tax year.

Appellants waived their right to an oral hearing so this matter is being decided based on the written record.

ISSUES

1. Have appellants established reasonable cause for the late payment of their 2017 taxes, such that the late payment penalty imposed against them pursuant to R&TC section 19132 may be abated?
2. Are appellants entitled to abatement of the estimated tax penalty imposed pursuant to R&TC section 19136?

FACTUAL FINDINGS

1. During 2016 and 2017, appellants, residents of Arizona, held a 50 percent interest in a limited liability company, treated as a partnership for United States and California tax purposes (hereafter, the Partnership), that held California real property.

2. The Partnership disposed of its California real property in 2016 and acquired, in 2017, replacement properties.
3. Appellants received advice from a qualified tax professional regarding these transactions. That advice led them to believe that the transactions qualified as a tax-free exchange of like-kind property under Internal Revenue Code (IRC) section 1031.[1] Appellants and the Partnership filed 2016 returns treating the transactions as tax-free.
4. Appellants subsequently changed tax advisors, and their new tax advisor, Kim Paskal (appellants' representative herein), detected a problem with the exchange. It appeared to her that some of the replacement properties had not be acquired within the period allowed under IRC section 1031(a)(3)(B). Under IRC section 1031(a)(3)(B), a taxpayer must complete the acquisition of replacement property by *the earlier of* 180 days after the taxpayer relinquishes its property, or "the due date (determined with regard to extension) for the transferor's return of the tax imposed . . . for the taxable year in which the transfer of the relinquished property occurs." Appellants previously had been unaware of the fact that the period for acquiring replacement property could be shorter than 180 days in situations where the transferor reports the disposition of the relinquished property on a return that is timely filed *without* extension, which is exactly what occurred here. This caused a portion of the exchange to fail to qualify as tax-free under IRC section 1031.
5. Ms. Paskal became aware of the above issue with respect to the exchange in March 2018 and discussed possible courses of action with appellants. Based upon her advice, appellants caused the partnership to request a private letter ruling from the IRS that they hoped would retroactively remedy the defect in the exchange. Ms. Paskal gathered the necessary documentation and prepared and filed a private ruling request with the IRS on or about May 22, 2018. The Partnership was requesting a ruling that would have retroactively granted it an extension of time to file its 2016 tax return under the authority of Treasury Regulations sections 301.9100-1 through 301.9100-3.
6. On August 27, 2018, the IRS refused to rule on the ruling request, stating as follows:

> Sections 301.9100-1 through 301.9100-3 of the Regulations provide the standards the Commissioner of Internal Revenue uses to determine whether to grant an extension of time to make statutory and regulatory elections. However, § 301.9100-1(b) provides that an election "does not

[1] California conforms to the provisions of IRC section 1031. (R&TC, § 18031.)

> include an application for an extension of time for filing a return under section 6081." Consequently, we cannot rule on Taxpayer's request relating to an extension of time for filing a return under [IRC] § 6081.

7. Promptly thereafter, appellants and the Partnership prepared amended tax returns for 2016 and filed them on or about September 7, 2018. Those returns reported that the exchange transaction was not, in fact, entirely tax-free as appellants and the partnership had previously reported on their original 2016 returns.
8. On October 11, 2018, appellants timely filed their California personal income tax return for 2017 pursuant to automatic extension. However, because appellants had not expected the exchange to fail to fully qualify for tax-free exchange treatment, they had not made any estimated or other tax payments towards their 2017 tax liability until the time they filed their return.
9. On their 2017 California return, appellants reported $3,188,198 of total taxable income, $241,160 of tax due, and self-assessed a $6,139 estimated tax penalty. Appellants paid this amount, plus interest, with their return.
10. Because appellants had not fully paid their 2017 tax liability by the payment due date of April 15, 2018, FTB automatically assessed a late payment penalty of $19,292.80 pursuant to R&TC section 19132. FTB transferred a $19,301.35 credit from appellants' 2016 tax year to satisfy the balance of penalties and interest due from appellants.
11. Appellants filed a timely claim for refund requesting abatement of the late payment and estimated tax penalties ($19,292.80 and $6,139, respectively). In their refund claim, appellants alleged that there was reasonable cause for their late payment of taxes and failure to pay estimated taxes based upon their good faith reliance on their former and current tax advisors in structuring and reporting the transactions at issue.
12. FTB issued a claim denial letter to appellants on February 11, 2019, from which appellants timely filed this appeal.

DISCUSSION

Issue 1. Have appellants established reasonable cause for the late payment of their 2017 taxes, such that the late payment penalty may be abated?

R&TC section 19001 generally provides that the personal income tax imposed "shall be paid at the time and place fixed for filing the return (determined without regard to any extension of time for filing the return).” The due date for filing and paying tax is the fifteenth day of the fourth month following the close of the taxable year (April 15th for individuals filing on a calendar year basis). (R&TC, § 19566.) R&TC section 19132 provides that a penalty shall be imposed when a taxpayer fails to pay the amount shown as due on the return on or before the due date. This penalty is intended to be punitive; it is imposed *in addition* to interest and the addition to tax for failing to pay estimated taxes (which are both designed to compensate the government for a taxpayer’s failure to pay amounts owed when due).

Under California law, the late payment penalty may only be abated upon a showing that the taxpayer’s late filing was attributable to “reasonable cause and not willful neglect.” (*Appeal of Friedman*, 2018-OTA-077P.[2]) In this appeal, there is no suggestion that appellants’ late payment was due to willful neglect, so we will only address whether appellants have established reasonable cause for their late payment.[3] (*Appeal of Sleight* (83-SBE-244) 1983 WL 15615.)

Appellants bear the burden of proof in establishing reasonable cause. (*Appeal of Sleight*, *supra*; *Appeal of Curry*, 86-SBE-048, 1986 WL 22783.) Appellants must establish that, although their payment was late, they acted as an ordinarily intelligent and prudent businessperson would have acted under the circumstances. (*Appeal of Curry*, *supra*; *see also Appeal of Scott*, 82-SBE-249, 1982 WL 11906.)

Appellants contend that reasonable cause exists on account of the following circumstances, none of which are disputed by FTB. During 2016, the Partnership in which appellants held a 50 percent interest attempted to engage in a tax-free exchange of like-kind property pursuant to IRC section 1031 (a Section 1031 exchange). Appellants sought the advice of a qualified tax professional to ensure that proper procedures were followed by the Partnership in order to successfully complete and report the exchange. Appellants were advised that they had 180 days from the date of the Partnership’s sale of the property (that is, until May 1, 2017) within which the Partnership could acquire replacement properties and qualify for tax-free treatment under IRC section 1031. However, unbeknownst to appellants, the deadline for acquiring replacement property had terminated prior to the expiration of the 180-day period, because the Partnership filed its 2016 return timely, without extension, on April 13, 2017. This

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[2] Precedential decision of the Office of Tax Appeals (OTA) may be found on OTA’s website at: <https://ota.ca.gov/opinions>.

[3] Appellants do not dispute FTB’s computation of the penalty amount.

shortened the 180-day period within which replacement properties could be acquired. (See R&TC, § 1031(a)(3)(B).) As a result, a portion of the section 1031 exchange became ineligible for tax-free treatment.

The parties involved (appellants, the Partnership, and appellants' former CPA) were unaware of the issue with respect to their Section1031 exchange until after the 2016 returns reporting the exchange had been filed. In fact, the issue was not discovered until March 2018, six weeks before the April 15th date when appellants' 2017 California tax liability was due. It was brought to appellants' attention by their new tax advisor, Kim Paskal, in connection with her preparation of appellants' 2017 returns.

On March 2, 2018, Ms. Paskal telephoned appellants and advised them that their completed exchange appeared not to have fully qualified for tax-free exchange treatment under IRC section 1031, and that this error could impact their already-filed 2016 returns as well as their yet-to-be-filed 2017 returns. Ms. Paskal presented appellants with various options for dealing with the issue, one of which included the Partnership requesting an IRS private letter ruling that, if successful, would have "saved" the transaction from being partially disqualified from tax-free exchange treatment. Ms. Paskal advised appellants that she believed that there was a 50/50 chance that the IRS would grant the letter ruling request. Appellants chose to proceed with the private letter ruling course of action without making full payment of the California tax that would be due if the IRS did not grant their ruling request.

Ms. Paskal's firm put together the ruling request and supporting documentation and submitted them to the IRS on May 22, 2018. Three months later, on August 27, 2018, the IRS wrote to appellants notifying them that they were unable to rule on the request because the relief that was sought—a retroactive grant of an extension of time for the Partnership to file its 2016 return—was not a permissible subject of a ruling request. Ms. Paskal immediately contacted appellants and recommended that they (i) amend their 2016 individual and partnership returns to reflect the partially failed tax-free exchange, and (ii) file their original 2017 individual and partnership returns reflecting the partially failed exchange. Appellants followed Ms. Paskal's recommendations. On or about September 17, 2018, appellants filed amended partnership tax returns for 2016, together with an original partnership tax return for 2017 reflecting the partially failed Section 1031 exchange. A few weeks later (on October 11, 2018), appellants filed an amended California income tax return for 2016, together with their original California income tax return for 2017, also reflecting the partially failed Section 1031 exchange. The partial failure of the Section 1031 exchange caused appellants to have to recognize a substantial amount of taxable capital gain that they did not previously anticipate owing. Appellant reported this income and paid the amount due with their timely filed 2017 California return, on or about October 11, 2018.

Appellants contend that they at all times relied on their qualified tax advisors in structuring and reporting the transactions involved. They contend (and we agree) that the Section 1031 exchange rules are complicated, and it was reasonable for appellants to have relied upon their tax advisors in structuring and reporting the transactions at issue. They also relied upon their current tax representatives in voluntarily and promptly amending their 2016 returns after they were advised that the IRS had rejected their private letter ruling request. Appellants assert these facts show they acted reasonably and in good faith in trying to ascertain and comply with their tax obligations.

FTB's perspective is different. FTB emphasizes that the problem with appellants' Section 1031 exchange had been identified in March 2018, prior to the April 15, 2018 deadline by which appellants could still pay their 2017 taxes without penalty. FTB also notes that appellants' representative advised appellants that there was only a "50/50 chance" of obtaining a favorable ruling from the IRS that would "save" their Section 1031 exchange.[4] Thus, appellants *could have* estimated and paid their proper tax liability before the deadline in order to guard against having an underpayment penalty imposed, but they intentionally chose a different course of action. Given these circumstances, FTB claims appellant lacked reasonable cause for their late payment.

While this appeal presents a close case, we find that the facts and circumstances do not establish that appellants had reasonable cause for failing to pay the taxes due for 2017 by the April 15, 2018 due date. By early March 2018, it had become clear to appellants' tax advisors and to appellants that the Section 1031 exchange had partially failed, even though they hoped to be able to retroactively correct the oversight that had generated the tax liability. That hope, however, does not negate the fact that at the time the return was filed, appellants knew or should have known they owed the taxes at issue but failed to timely pay them. The decision to not pay

[4] FTB contends that appellants' counsel's 50/50 estimate overstated the possibility of succeeding with its IRS private letter ruling strategy. That may be correct, but we have no reason to question whether the 50/50 estimate was not made in good faith and that appellants reasonably relied on that good faith estimate.

the taxes might be understandable (Why pay taxes now that might not be due if the IRS were to grant you the retroactive relief you requested?), but it does not satisfy the reasonable cause standard. Applying the "prudent businessperson" standard discussed above, we believe that a prudent businessperson would (or at least should) have paid the taxes believed to be due and owing based on the facts as they existed at the time the taxes were due. Accordingly, we find that appellants have not shown reasonable cause for their late payment of tax.

<u>Issue 2. Are appellants entitled to abatement of the estimated tax penalty imposed pursuant to R&TC section 19136</u>?

Appellants made no payments of estimated taxes towards their 2017 California tax liability, because at the time their underpayments were due, they reasonably believed, based upon the advice of their tax advisors, that their property exchanges qualified as tax-free under IRC section 1031. When that belief turned out to be incorrect, appellants self-assessed and paid a $6,639 "addition to tax" under R&TC section 19136 with their 2017 tax return.

Although the "addition to tax" for failing to timely pay estimated tax is commonly referred to as a penalty, it is not punitive in nature. It is similar to an interest charge, in that it is calculated applying the interest rate imposed on underpayments on the amount of the underpayment of estimated tax for the period of time from the dates the estimated payments were due, until the time the tax liability became due. (See IRC, § 6654(a).)

Appellants seek a refund of the amount paid on the same reasonable cause grounds that we discussed above. However, neither the estimated tax penalty imposed by R&TC section 19136, nor the federal provision upon which it is based and to some extent incorporates (IRC section 6654), contain a reasonable cause defense. (*Appeal of Saltzman*, 2019-OTA-070P; *Adams v. Commissioner*, T.C. Memo. 2013-7; *Farhoumand v. Commissioner*, T.C. Memo. 2012-131; *Nasir v. Commissioner*, T.C. Memo. 2011-283; see also *Appeal of Weaver Equipment Co.* (80-SBE-048) 1980 WL 4976.) Thus, appellants' reasonable cause contentions are irrelevant.

Instead, appellants must show that they qualify under one of the penalty exceptions contained in the statutes themselves. (*Nitschke v. Commissioner*, T.C. Memo. 2016-78.) Appellants contend that they are entitled to waiver of the penalty pursuant to the exception contained in IRC section 6654(e)(3)(A), which provides that the penalty may be waived if the underpayment is the result of a "casualty, disaster, or other unusual circumstances" that would cause the imposition of the addition to tax to be "against equity and good conscience." However, appellants' realization of a large gain from the sale of real property is hardly a "casualty, disaster or other unusual circumstance"; neither is it "against equity and good conscience" to impose what is essentially an interest charge for failing to pay the estimated taxes on that gain when due. (See generally *Farhoumand v. Commissioner*, *supra* [gains attributed to extreme stock market volatility not an "unusual occurrence" warranting waiver of estimated tax penalty].) Accordingly, the failure to pay estimated tax penalty may not be abated.

HOLDINGS

Appellants are liable for the late payment and estimated tax penalties imposed against them for 2017.

DISPOSITION

FTB's denial of appellants' refund claim is sustained in full.

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Jeffrey I. Margolis
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Jeffrey I. Margolis
Administrative Law Judge

We concur:

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John O Johnson
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John O. Johnson
Administrative Law Judge

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E. L. Ewing
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Elliott Scott Ewing
Administrative Law Judge

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