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2021 – OTA – 159
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **K&R HOLDCO, INC.**	) OTA Case No. 20056188

OPINION

Representing the Parties:

For Appellant: Brendan P. O'Connor, Attorney at Law
RJS Law – A Tax Law Firm

For Respondent: Brian Werking, Tax Counsel III

K. GAST, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19324, K&R Holdco, Inc. (appellant) appeals an action by respondent Franchise Tax Board (FTB) denying appellant's claim for refund totaling $67,874.38 in penalties for the 2018 tax year.[1] Appellant waived its right to an oral hearing, and therefore this matter is being decided based on the written record.

ISSUES

1. Whether appellant is liable for the late-filing penalty.
2. Whether appellant is liable for the per-shareholder late-filing penalty.
3. Whether appellant is liable for the estimated tax penalty.

FACTUAL FINDINGS

1. Appellant is an S corporation that was incorporated in Delaware in 2018. It has two shareholders. It untimely filed its initial 2018 California S corporation franchise or

[1] This amount consists of a late-filing penalty of $60,793.50 imposed under R&TC section 19131, a per-shareholder late-filing penalty of $288 imposed under R&TC section 19172.5, and an underpayment of estimated tax penalty (estimated tax penalty) of $6,792.88 imposed under R&TC section 19142. We note that although the record contains conflicting information as to which of these penalties are at issue, we will address all three because appellant's refund claim lists $67,874.38 as the disputed amount.

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income tax return on October 31, 2019. On that return, appellant reported a tax due, and because it had made no previous payments, such as estimated taxes, it submitted full payment with the return.

2. Subsequently, FTB imposed the three penalties noted above and issued a notice to appellant reflecting an outstanding balance due, plus interest, which appellant paid.
3. Appellant then filed a claim for refund of $67,874.38, requesting abatement of the penalties on reasonable cause grounds.
4. FTB denied the refund claim and this timely appeal followed.

DISCUSSION

Issue 1: Whether appellant is liable for the late-filing penalty.

R&TC section 19131 imposes a penalty for the failure to file a return on or before the due date, unless it is shown that the late filing is due to reasonable cause and not due to willful neglect. Here, it is undisputed that FTB properly imposed and computed the late-filing penalty. Because FTB does not assert willful neglect, the only issue is whether appellant has demonstrated reasonable cause for its late filing.

To establish reasonable cause, the taxpayer must show that the failure to file a timely tax return occurred despite the exercise of ordinary business care and prudence, or that cause existed as would prompt an ordinarily intelligent and prudent businessperson to have so acted under similar circumstances. (*Appeal of GEF Operating, Inc.*, 2020-OTA-057P.) A late-filing penalty imposed by FTB is presumed to be correct, and the burden of proof is on the taxpayer to establish that reasonable cause exists to support an abatement of the penalty. (*Appeal of Xie*, 2018-OTA-076P.)

As background, the record indicates that appellant was formed in 2018 as part of a complex "merger and buyout transaction" involving its predecessor entity and what appears to be third-party entities based in Maine.[2] The crux of appellant's contention is that it exercised

[2] According to a slide deck detailing the steps of the acquisition structure, it appears appellant's predecessor entity, K&R Network Solutions, was an S corporation that merged out of existence into a limited liability company, which in turn became indirectly owned by appellant and the third parties through a joint venture.

ordinary business care because it sought and relied on competent outside tax advice to determine its filing and compliance requirements due to this "transaction."[3]

In *U.S. v. Boyle* (1985) 469 U.S. 241, 251-252 (*Boyle*),[4] the U.S. Supreme Court held that "[t]he failure to make a timely filing of a tax return is not excused by the taxpayer's reliance on an agent, and such reliance is not 'reasonable cause' for a late filing . . . ." The Court, however, observed that reasonable cause may exist if a taxpayer relies on the advice of an accountant or attorney with respect to substantive matters of tax law, such as whether a return needs to be filed in the first place, even when such advice turned out to have been mistaken. (*Id*. at pp. 250-251.)

If a taxpayer relies on improper advice of an accountant or attorney as to a substantive matter of tax law, failing to file a return in reliance on that advice may be considered reasonable cause if two conditions are met. (*Rohrabaugh v. U.S.* (7th Cir. 1979) 611 F.2d 211, as cited in *Boyle*, *supra*, at p. 244.) These conditions are (1) that the person relied on by the taxpayer is a tax professional with competency in the subject tax law, and (2) that the tax professional's advice is based on the taxpayer's full disclosure of the relevant facts and documents.

Appellant contends that for the 2018 tax year, it used a new tax preparer based in Maine (Maine preparer) to prepare and file its federal and California tax returns in order to properly report the transaction at appellant's (i.e., the S corporation's) level. Appellant, however, states that it retained its predecessor entity's previous tax preparer, based in California, to (apparently) do one of its individual shareholder's tax returns.[5] It alleges that on September 13, 2019, several days prior to the September 15, 2019 automatic extension due date for filing the California return, the Maine preparer sent a Schedule K-1 (presumably federal) to the shareholder's preparer who "noticed there was not a California return [for appellant] and the proceeds from the transaction were not on the K-1 [again, presumably the federal Schedule K-1]." Appellant asserts that on September 19, 2019, several days after the California extended due date, the

[3] While unclear, we interpret appellant's references to "transaction" as its sale of interests in a joint venture, which appears to have triggered a net gain of about $17 million that it recognized on its late-filed California tax return for the year at issue.

[4] Because the relevant language of R&TC section 19131 pertaining to the reasonable cause exception is patterned after Internal Revenue Code section 6651, the federal courts' interpretation of the "reasonable cause" standard is persuasive authority in determining the proper construction of this California statute. (*Andrews v. Franchise Tax Bd.* (1969) 275 Cal.App.2d 653, 658; *Rihn v. Franchise Tax Bd.* (1955) 131 Cal.App.2d 356, 360.)

[5] Appellant asserts that it used the Maine preparer because he was the tax preparer for the other parties to the transaction and the California-based tax preparer lacked the credentials to perform an accounting review of the transaction.

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Maine preparer "re-reviewed the transaction and determined that he was incorrect on what entity level the transaction occurred." Then, on October 24, 2019, the Maine preparer provided the shareholder's preparer "with amended federal and California [S corporation] returns," with the latter return being untimely filed on October 31, 2019.

Without needing to decide whether the two conditions for relying on the advice of a tax professional are satisfied, as a threshold matter, appellant has not shown the Maine preparer provided any substantive tax law advice to not file a 2018 California S corporation return. Rather, the evidence shows that the Maine preparer simply made a mistake—or in appellant's own words, an "error"—by overlooking the fact that appellant had a California filing obligation. Indeed, appellant admits that it "did not receive any written correspondences from [the Maine preparer] stating that [it] did not have a California filing requirement [for] 2018," and there is no evidence to suggest oral advice was provided to not file. Although appellant alleges that "[t]he omission of a California return was a conscious decision made by [the Maine preparer] based on his mistaken belief that a California return was not required," there is no support for this or why the preparer believed this to be true when he knew, as appellant acknowledges, that its predecessor entity had historically filed in California.[6] (See *Appeal of GEF Operating, Inc.*, *supra* [unsupported assertions are insufficient to satisfy a taxpayer's burden of proof].)

In short, what seems clear is that appellant relied on its Maine preparer to file a 2018 California tax return that properly reported the S corporation-level transaction, and not for the preparer's substantive tax advice on whether that return needed to be filed in the first place.[7] But simply relying on an agent, such as a tax preparer, to ensure timely compliance is not reasonable cause. (*Boyle*, *supra*, 469 U.S. 241, 251-252.) Lastly, we note that California does not permit penalty abatement due to good filing history; instead, reasonable cause, which is lacking here,

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[6] In fact, the email exchanges in September 2019, between the Maine preparer and the shareholder's preparer, support the opposite factual conclusion. In a September 19, 2019 email, the Maine preparer simply discusses the mistake of not originally reporting the transaction at the S corporation level and never mentions appellant is not required to file a California return. And in a September 20, 2019 reply email, the shareholder's preparer simply states that he wants to make sure the shareholder's gain is reported by the correct entity and the shareholder's California compliance is accurate and never mentions that appellant should or should not file a California tax return in the first place.

[7] Appellant also asserts that it exercised ordinary business care because its predecessor entity's owners sought advice from competent outside tax counsel to determine the predecessor's filing and compliance requirements from the complex merger transaction. However, the late filing at issue here is appellant's, and not its predecessor entity's. Moreover, the mere act of seeking tax advice does not entitle appellant to abatement based on reasonable cause.

must be shown.[8] Accordingly, appellant has not established reasonable cause to abate the late-filing penalty.

Issue 2: Whether appellant is liable for the per-shareholder late-filing penalty.

R&TC section 19172.5 imposes a per-shareholder late-filing penalty on an S corporation for failing to file a return on or before the due date, unless it is shown that the late filing is due to reasonable cause. As with the late-filing penalty, it is undisputed that FTB properly imposed and computed this penalty and the only issue is whether appellant has demonstrated reasonable cause for its late filing. The taxpayer bears the burden of proving reasonable cause exists, which requires a showing that it acted as an ordinarily intelligent and prudent businessperson would have acted under similar circumstances. (*Appeal of Quality Tax & Financial Services, Inc.*, 2018-OTA-130P.)

Appellant presents the same arguments here as it does for the late-filing penalty. However, for the reasons expressed above, appellant has not established reasonable cause to abate the per-shareholder late-filing penalty.

Issue 3: Whether appellant is liable for the estimated tax penalty.

A corporation that underpays its estimated tax is liable for an addition to tax (i.e., a penalty) equal to a specified rate of interest applied to the amount of the underpayment. (R&TC, §§ 19142, 19144.) Relief from the estimated tax penalty is not available upon a showing of reasonable cause, although a few limited statutory exceptions to the penalty exist. (*Appeal of Weaver Equipment Co.* (80-SBE-048) 1980 WL 4976; R&TC, §§ 19147, 19148.)

Here, again, there is no dispute that FTB properly imposed and computed this penalty. Rather, appellant requests abatement based on reasonable cause. However, since no general reasonable cause exception exists, and appellant does not argue or provide evidence that the limited statutory exceptions to the penalty apply, there is no basis for abatement.

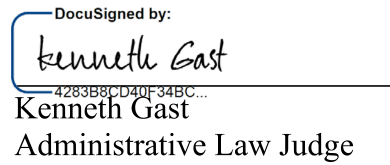
[8] The California Legislature has considered and declined to adopt bills that would change California law to allow a first-time abatement of timeliness-related penalties for taxpayers based solely on their history of timely filing and payment. (See Assem. Bill No. 1777 (2013-2014 Reg. Sess.).)

HOLDINGS

1. Appellant is liable for the late-filing penalty.
2. Appellant is liable for the per-shareholder late-filing penalty.
3. Appellant is liable for the estimated tax penalty.

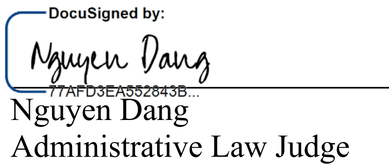
DISPOSITION

FTB's action is sustained.

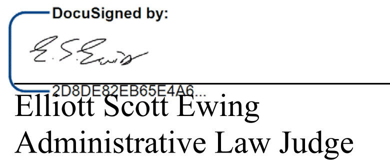


Kenneth Gast
Administrative Law Judge

We concur:



Nguyen Dang
Administrative Law Judge



Elliott Scott Ewing
Administrative Law Judge

Date Issued: 3/24/2021