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2021 – OTA – 026
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:) OTA Case No. 18053219

C. FELIPE JR. AND
T. FELIPE

OPINION

Representing the Parties:

For Appellants: Mark Bernsley, Esq.

For Respondent: David Hunter, Tax Counsel IV
Marguerite Mosnier, Attorney V

For Office of Tax Appeals: Neha Garner, Tax Counsel III

J. MARGOLIS, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, C. Felipe and T. Felipe (appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing deficiencies in tax and penalties for the 2009-2014 tax years.

Office of Tax Appeals (OTA) Administrative Law Judges Jeffrey Margolis, Kenneth Gast, and Nguyen Dang held a teleconference hearing for this matter on August 18, 2020.[1] At the conclusion of the hearing, the record was closed, and the matter was submitted for decision.

ISSUES

1. Whether appellants are entitled to deduct, as a theft loss or a tax preparer fee, a $25,792 payment made in 2014.
2. Whether appellants are liable for the accuracy-related penalties proposed for 2011, 2012, 2013 and 2014.
3. Whether appellants are liable for the late-filing penalties proposed for 2011 and 2013.

[1] The hearing was noticed for Cerritos, California, but in light of the COVID-19 pandemic, the parties agreed to conduct the hearing electronically.

FACTUAL FINDINGS

1. Appellants are California residents. They were born and educated in the Philippines. Appellant-husband moved to the United States in 1980, when he was twenty-five. Appellant-wife moved to the United States in 1982. Appellants both work in the medical field. Appellant-husband is a clinical lab scientist. Appellant-wife is a registered nurse.
2. Appellants are not well-versed in matters of U.S. taxation. For at least three years prior to the years at issue in this appeal, appellants hired a third-party tax return preparer to prepare their tax returns. The preparer did so for an annual fee of $300-$400 a year.
3. Appellants made a real estate investment in 2005 (in Nevada) and in 2006 (in California) that foundered during the Great Recession. They lost the Nevada property to foreclosure in 2009.
4. Appellants filed a voluntary petition in bankruptcy under chapter 13 of the Bankruptcy Code (title 11, United States Code) on July 7, 2009. The petition was dismissed several months later due to their attorney's failure to file required information. Appellants subsequently filed three other bankruptcy petitions that were dismissed by the bankruptcy court. A fifth bankruptcy filing by appellants was filed on July 6, 2011. It resulted in a standard discharge on January 17, 2017.
5. In their bankruptcy actions, appellants were represented (at least initially) by Carlo O. Reyes, a California attorney. Mr. Reyes eventually was disbarred from the practice of law in California.
6. Mr. Reyes also prepared, on behalf of appellants, a civil complaint against a mortgage lender and servicing corporation, which asserted that appellants had sustained damages in excess of $2,000,000 from fraud and other violations of California law.[2] The complaint was never filed.
7. In 2010, appellants retained a new tax advisor, Ms. Samson, who was recommended to them by a friend and coworker. According to appellant-husband's testimony:

> [Ms.] Samson was introduced to us by a coworker and a friend of mine at work. And as he explained it to me, she's – she's a good preparer, a qualified one and everything. And for some reason, you know, because I trusted my friend too. I said okay. Maybe I give her a chance to do it …. And for reason in my heart, maybe I give her a chance to do my taxes, you

[2] The record does not reveal when this complaint was prepared.

> know. And anyway she does a good job. She belong to – as she explained it. She belong to a big congregation … and she's the one preparing for almost everybody there. So I agreed ….

8. The record does not indicate whether Ms. Samson was licensed, qualified, or competent to prepare tax returns.
9. Appellants claim that Ms. Samson agreed to prepare appellants' federal and California income tax returns in exchange for a fee equal to 20 percent of any tax refunds received. Appellant-husband contends that he signed a written agreement to this effect, but none has been produced. Appellant-husband testified that when Ms. Samson spoke with him about what her fee would be, she would say, "we'll see." He testified: "It's always like that. She said, we'll see, you know, what things we could do and maybe at that time pay me …." He also testified that: "I did sign with her. She asked me to sign before I … gave her the check [in April 2014]."
10. Appellants assert that they timely provided Ms. Samson with whatever information she requested for the preparation of their returns. However, Ms. Samson did not timely prepare appellants' returns.
11. Commencing in 2014 and continuing into 2015, Ms. Samson began delivering the tax returns she had prepared for appellants. Appellants signed and filed those returns promptly upon receipt, on the dates indicated below:
    a. Appellants late-filed their 2009 California return on or about February 4, 2013.
    b. Appellants late-filed their 2010 California return on or about February 15, 2013.
    c. Appellants late-filed their 2011 California return on or about September 4, 2013.
    d. Appellants late-filed their 2012 California return on or about January 3, 2014.
    e. Appellants late-filed their 2013 California return on or about February 15, 2015.
    f. Appellants timely filed their 2014 California return on or about July 15, 2015.
12. Although Ms. Samson was appellants' paid tax return preparer, she did not sign appellants' returns as preparer.
13. Appellants attached Internal Revenue Service (IRS) Forms 4684, "Casualties and Thefts," to their California returns for the years at issue claiming substantial theft/casualty losses. In the Forms 4684, appellants asserted that that they were victims of grand theft and fraud by lending institutions on property acquisitions they had made in

California and Nevada. Appellants claimed the following theft/casualty losses on their returns: $278,095 for 2009; $278,095 for 2010; $312,340 for 2011; $282,171 for 2012; $306,013 for 2013; and $230,240 for 2014. On appeal, appellants concede that the claimed theft/casualty losses are not allowable. Hence, those disallowances are no longer at issue.

14. Appellants' 2009 return also claimed losses totaling $156,627 with respect to the foreclosure of their Nevada property.[3] Although FTB originally disallowed $149,052 of these losses in its Notice of Action for 2009, on appeal, FTB concedes that the originally claimed losses, totaling $156,627, are deductible.

15. Appellants' claimed losses generated substantial federal and California income tax refunds. The tax refunds appellants received for the six years at issue totaled $534,011 ($401,491 from the IRS and $132,520 from FTB).

16. During the three years prior to the years at issue, appellants' returns were prepared by a different tax preparer, one that actually signed appellants' returns as preparer. Appellants did not claim any tax refunds of withheld amounts on those returns. In fact, on those returns, appellants reported owing significant amounts of taxes to the IRS and FTB in addition to their tax withholdings. For 2006, appellants owed $22,702 of additional federal income tax[4] and $4,521 of additional California income tax. For 2007, appellants owed $11,145 of additional federal income tax and $3,091 of additional California income tax. For 2008, appellants owed $20,810 of additional federal income tax and $6,420 of additional California income tax.

17. Appellants paid Ms. Samson (or her son at her request) a total of $62,401. During the years at issue, however, they made only one payment, a $25,792 cashier's check dated April 17, 2014, made out to Ms. Samson's son. The notation on the check states that the payment was for "tax fees audit reconciliation." This notation was put on the check at Ms. Samson's request. Appellant-husband testified that: "Honestly, I don't know about – what's … all this reconciliation." In subsequent years, appellants made further payments to Ms. Samson or, more commonly, her son as her designee: $13,787 on

[3] These losses were identified in FTB's Notice of Action for 2009 as a Schedule C loss of $149,052 and a Section 1231 loss of $7,575.

[4] Appellants were unable to pay this amount with their return. They requested the IRS put them on an installment payment plan.

May 4, 2015; $4,822 on April 22, 2015; $3,662 on October 2, 2015; $2,500 on October 2, 2015; and $11,838 on January 5, 2016.

18. Appellants did not claim a deduction for any amounts paid to Ms. Samson (or her son) on their 2014 California income tax return.[5] On appeal, however, appellants claim that the $25,792 payment is deductible either as a tax preparation fee under Internal Revenue Code (IRC) section 212(3) or as a theft or embezzlement loss under IRC section 165.[6]

19. FTB audited appellants' income tax returns for the years at issue. Eventually, FTB issued Notices of Proposed Assessment and, subsequently, Notices of Action (NOAs) for the years at issue. In the NOAs, FTB determined deficiencies in tax and penalties for the years at issue as follows:

    a. For 2009, $28,381 of additional tax. On appeal, FTB has agreed to allow losses totaling $156,627 with respect to the foreclosure of their Nevada property.
    b. For 2010, $25,037 of additional tax.
    c. For 2011, $27,193 of additional tax, a late-filing penalty of $541.60, and an accuracy-related penalty of $5,438.60.
    d. For the 2012, $24,148 of additional tax and an accuracy-related penalty of $4,829.60.
    e. For 2013, $25,638 of additional tax, a late-filing penalty of $392.20, and an accuracy-related penalty of $5,127.60.
    f. For 2014, $16,736 of additional tax and an accuracy-related penalty of $3,347.20.

20. According to FTB's NOAs, the accuracy-related penalties were proposed based upon FTB having determined that the deficiencies constituted "substantial underpayments of income tax" within the meaning of IRC section 6662(b)(2) and (d).

21. The deficiencies in tax that FTB claims are still due from appellants for 2009-2014 are attributable to the disallowed theft losses claimed by appellants. Appellants'

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[5] Although appellants' 2014 California tax return is not in evidence, in contesting appellants' claim for a deduction for tax preparation fees, FTB has not asserted that appellants already claimed a deduction for tax preparation fees on their 2014 return.

[6] Because the term "theft" as used in IRC section 165 includes embezzlement (see Tres. Reg. § 1.165–8(d)), we hereafter refer to appellants' "theft and embezzlement" claim simply as a theft loss claim under IRC section 165.

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counsel has stated that he "has found no basis supporting a theft loss deduction in the amounts claimed by the return preparer."

22. Appellants timely filed this appeal from FTB's NOAs.

DISCUSSION

Issue 1 – Whether appellants are entitled to deduct, as a theft loss or a tax preparer fee, a $25,792 payment made in 2014.

Deductions are a matter of legislative grace and taxpayers bear the burden of establishing their entitlement thereto. (*INDOPCO, Inc. v. Commissioner* (1992) 503 U.S. 79, 84; *Appeal of Telles* (86-SBE-061) 1986 WL 22792.) To carry that burden, taxpayers must point to an applicable statute and show by credible evidence that they come within its terms. (*Appeal of Telles, supra*.) Unsubstantiated assertions by taxpayers generally are not sufficient to satisfy the burden of proof. (*Appeal of Magidow* (82-SBE-274) 1982 WL 11930.)

Appellants contend they are entitled to a miscellaneous itemized deduction for the $25,792 amount paid to Ms. Samson's son, either as a theft loss under IRC section 165, or as a tax preparation fee under IRC section 212(3).[7] To deduct this amount as a theft loss, appellants must prove: (1) the occurrence of a theft; (2) the amount of the theft loss; and (3) the year in which the taxpayers discover the theft loss. (IRC, §165(a), (c), (e); see also *McNely v. Commissioner*, T.C. Memo. 2019-39.) The IRS has defined the term "theft" under IRC section 165 "to include, but … not necessarily be limited to, larceny, embezzlement, and robbery." (Tres. Reg. § 1.165-8(d).) Whether there has been a theft loss within the meaning of IRC section 165(c)(3) depends upon the law of the jurisdiction where the loss was sustained. (*Luman v. Commissioner* (1982) 79 T.C. 846, 860.)

Appellants allege that Ms. Samson committed theft by depriving them of their funds by "false pretenses," because she falsely represented to them that she was qualified to prepare their returns. However, even if appellants were the victims of theft under California law, appellants still would not be entitled to a theft loss deduction in 2014, because under IRC section 165(e), a theft loss may only be claimed in the year in which the theft is *discovered*. (See also *Jeppsen v. Commissioner* (10th Cir. 1997) 128 F.3d 1410, 1414 ["Under the Internal Revenue Code, a theft loss is not 'sustained' at the time the theft actually occurs. Rather, 'any loss arising from theft

[7] California conforms to both sections. (See R&TC, § 17201.)

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shall be treated as sustained during the taxable year in which the taxpayer discovers such loss.' I.R.C. § 165(e)."].) The evidence clearly shows that appellants had not "discovered" Ms. Samson's purported theft during 2014, because they continued to voluntarily make payments to her until at least 2016. Thus, appellants' theft loss claim must be disallowed.[8]

Whether appellants are entitled to a deduction under IRC section 212(3) for the amount paid to Ms. Samson's son in 2014 presents a more difficult question. IRC section 212 provides, in pertinent part, as follows: "In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year … (3) in connection with the determination, collection, or refund of any tax." The Treasury Regulation promulgated under IRC section 212 provides that, for a tax-related expense to be deductible under IRC section 212(3), it "must be reasonable in amount and must bear a reasonable and proximate relation" to the determination, collection, or refund of any tax. (See Treas. Reg. § 1.212-1(d); IRC, § 212(3).)

Appellants contend that the $25,792 check they paid to Ms. Samson's son in 2014 was actually for services rendered by Ms. Samson in preparing their 2009-2014 years' tax returns. Allegedly, Ms. Samson had agreed to prepare appellants' tax returns in exchange for appellants' promise to pay her 20 percent of any refunds they received from the IRS and FTB. The returns prepared by Ms. Samson generated tax refunds for the years 2009-2014 totaling $534,011 ($401,491 from the IRS and $132,520 from the FTB), representing virtually all of the income taxes that had been withheld from appellants' wages.[9] Under the purported agreement between appellants and Ms. Samson, appellants were obligated to pay 20 percent of this amount to Ms. Samson. However, they paid a considerably lesser amount, $62,401, to her and her son (as her designee) over the period from 2014 through 2016 ($25,792 in 2014, $24,771 in 2015, and $11,838 in 2016).[10] Nevertheless, appellants contend that they entered into the purported contingency fee agreement with Ms. Samson in good faith, and that the fee generated thereby was not excessive because at the time the agreement was entered into, the amount of refunds

[8] Our disallowance of the deduction on this ground should not be read to imply that appellants were the victims of theft. In this regard, we note that appellants did not file a police report concerning the purported theft, nor did they bring a civil suit against Ms. Samson for theft.

[9] Only FTB sought to recover those refunds. The IRS did not audit appellants' returns for the years at issue.

[10] The reasons for this discrepancy were unexplained.

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appellants would receive—and, as a result, the amount of the fee due Ms. Samson—was unknown.

FTB notes that the $25,792 paid in 2014 was paid to Ms. Samson's son, not Ms. Samson, and that appellants have failed to produce any written agreement relative to their arrangement with Ms. Samson. The check itself states that the amount paid was for an "audit reconciliation," although no evidence was presented as to what that term means, or that any "audit reconciliation" services actually were provided. Nevertheless, FTB does not seriously dispute appellants' contention that Ms. Samson prepared appellants' returns. FTB's primary contention is that the fee does not satisfy the requirement that the fee be "ordinary and necessary" because the amount of the fee was unreasonable and excessive. FTB's argument is based, in principal part, on appellant-husband's testimony that, in prior years, appellants paid $500-$600 per year to have their returns prepared, and those returns were prepared by a legitimate tax return preparer.[11]

Neither party has provided us with any case authorities indicating how the term "ordinary and necessary" is interpreted in the context of deducting an amount paid for tax return preparation services under IRC section 212(3). However, there is also an "ordinary and necessary" requirement contained elsewhere in the IRC, in IRC section 162. It applies to deductions claimed under a different part of the IRC (part VI of subtitle A, chapter 1, subchapter B),[12] and a considerable body of law has developed as to the meaning of that term in connection with its use in IRC section 162. We find it appropriate to look to the authorities interpreting the "ordinary and necessary" standard under IRC section 162 in interpreting the "ordinary and necessary" standard contained in IRC section 212. (See generally *Johnsen v. Commissioner* (6th 1986) 794 F.2d 1157, 1162 [IRC sections 162(a) and 212 are to be considered in *pari materia*].)

As applied to the situation before us, the provisions of Treasury Regulation section 1.162-7 are particularly helpful; they consider whether and to what extent amounts paid

[11] FTB also notes that Circular 230 (31 C.F.R., subtitle A, part 10, published June 12, 2014), which governs persons who practice before the IRS, prohibits preparing a federal tax return for a contingent fee. (The version of Circular 230 that was in effect during 2010, when the purported agreement with Ms. Samson was entered into, also contains this prohibition. (See <https://www.irs.gov/pub/irs-prior/pcir230--2005.pdf>, § 10.28 [accessed Oct. 7, 2020].) Appellants, however, were not sophisticated in tax matters and presumably would not have known that a contingent fee agreement with Ms. Samson apparently would have violated the provisions of Circular 230. In any event, our concern here is whether the fee was unreasonable and excessive, not whether the fee agreement violated whatever ethical requirements might have applied to Ms. Samson. (See generally *Van Sickle v. Commissioner*, T.C. Memo. 1986-538.)

[12] IRC section 212(3) is contained in part VII of subtitle A, chapter 1, subchapter B of the IRC.

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for personal services are deductible as ordinary and necessary business expenses in situations where, as here, the amounts paid were based upon a contingent compensation agreement. Treas. Reg. section 1.162-7(b) states, in pertinent part, as follows:

> (2) The form or method of fixing compensation is not decisive as to deductibility. … Generally speaking, *if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered*, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, *it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.*
>
> (3) *In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.*

(Treas. Reg. § 1.162–7(b)(2) & (3), italics added.)

The U.S. Tax Court applied the principles contained in Treas. Reg. section 1.162-7(b) to a contingent compensation agreement in *Alondra Industries, Ltd. et al. v. Commissioner*, T.C. Memo. 1996-32 (*Alondra Industries*).) There, the court explained:

> Contingent compensation agreements can be upheld and compensation paid under them held to be deductible under appropriate circumstances. However, we expressly stated in *Automotive Inv. Dev., Inc. v. Commissioner*, [T.C. Memo. 1993-298], that even the contingent compensation formula there approved might in other circumstances result in compensation that is unreasonable under section 162(a)(1). Compensation, even under a contingent compensation formula, is in any case limited to what is reasonable under all the circumstances, which is in general such amount as would ordinarily be paid for like services by like enterprises under the circumstances.
>
> Where there is no free bargain between the parties as contemplated by section 1.162-7(b)(2), Income Tax Regs., a contingent compensation agreement will not be dispositive of what is deductible under section 162(a)(1). The court in such a case is free to make its own determination of what is reasonable compensation.

(*Alondra Industries*, *supra*, 1996 WL 31250 at p. *13, internal citations omitted.) Ultimately, however, "[w]hether an expenditure that is claimed as a deduction under [IRC] section 162(a)(1)

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is reasonable compensation for services rendered is a question of fact that must be decided on the basis of the facts and circumstances." (*Id.* at p. *14.)

Appellants contend that one cannot use hindsight to evaluate the reasonableness of the fee, because the amount was paid pursuant to an agreement that was entered into in good faith prior to the time it was known whether any refunds would be received. While that principle might generally be true, we reject it here for several reasons.

First, appellants have not provided us with any written proof of the agreement with Ms. Samson (other than proof of the payments made to her and her son), so it is not clear what the terms of the agreement were, or when the agreement was actually made. (See generally *Cohan v. Commissioner*, T.C. Memo. 2012-8 [court refuses to allow taxpayer to increase basis in asset for "success fee" paid to a law firm for which there was no written contract].) We also note that the amount ultimately paid was *not* consistent with the terms of the purported agreement; it did *not* equal 20 percent of the refunds received. Thus, we have reason to question whether the purported agreement was a bona fide contingent fee agreement for the provision of tax return preparation services that was entered into before services were rendered.

Second, we do not know how much of the total amount paid to Ms. Samson and her son was for tax preparation and how much was for other services (such as the purported "audit reconciliation") that may or may not be deductible. Even if we assume that the entire $62,401 amount was paid for the preparation of six years of appellants' tax returns, appellants still would have paid $10,400 per year—more than 26 times the amount they had previously paid for return preparation—which is unreasonably large under the circumstances.[13] (See Treas. Reg. § 1.162-7(b)(3) ["In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances."].) Because the amount paid was far in excess of the amounts appellants previously paid for comparable services, the question naturally arises: What were appellants really paying Ms. Samson for? The evidence suggests that appellants were paying her *for tax refunds* generated by the bogus deductions claimed on the returns, and the preparation of appellants' tax returns was merely ancillary to that objective.

In this regard, we note that appellants did not do any due diligence in checking out Ms. Samson's qualifications to provide them with tax advice and prepare their returns; they

[13] In this regard, we reject appellant-husband's testimony that they previously paid $500-$600 per year to have their prior years' returns prepared, as the record shows that they deducted $400 for tax preparation fees on their 2006 and 2007 returns, and $300 on their 2008 return.

simply relied upon the recommendation of a friend and coworker.[14] Moreover, appellants did not change their preparer even though Ms. Samson failed to complete her preparation of appellants' 2009 return *for almost three years*. Despite this, when the returns finally were completed, appellants paid Ms. Samson whatever fees she requested of them.

Most significantly, appellants did not question whether the results Ms. Samson obtained for them, namely, refunds of over half a million dollars of their income tax withholdings, was legal. Appellants ignored the red flags that arose from Ms. Samson's conduct and claimed baseless deductions on the returns she prepared for them. This reinforces our conclusion that appellants were paying her primarily for unallowable deductions, not for bona fide tax preparation services. Amounts paid to Ms. Samson (or her son) to create bogus tax deductions are not deductible under IRC section 212. (See *Brown v. Commissioner* (1985) 85 T.C. 968, 1000 [fees paid to generate sham deductions "are, at best, personal expenditures which are not deductible under section 162 or 212"].)

Nevertheless, because FTB admits that Ms. Samson prepared appellants' returns for the years at issue (despite her failure to sign them as preparer), we will allow appellants to deduct the portion of the amount paid to her that the record suggests would be a reasonable tax preparation fee. Where, as here, a taxpayer proves that some part of an expenditure was made for deductible purposes and the record contains sufficient evidence for us to make a reasonable allocation, we may make such an allocation. (*Cohan v. Commissioner* (2d Cir. 1930) 39 F.2d 540.) The record in this case reveals that appellants paid $300-$400 in prior years to have their federal and state returns prepared. Based on this evidence, we will allow appellants to deduct $2,400 in 2014 ($400 for each year that Ms. Samson prepared appellants' returns) under IRC section 212(3).[15] (See *Wakefield v. Commissioner*, T.C. Memo. 2015-4.)

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[14] The person(s) who allegedly recommended Ms. Samson to appellants did not testify at the hearing.

[15] For the 2014 tax year, appellants' expenses related to tax preparation or representation would be deductible, if at all, as miscellaneous itemized deductions. As such, only the amount of the total itemized deductions which exceeded two percent of adjusted gross income are deductible pursuant to R&TC section 17076 and IRC section 67.

Issue 2 – Whether appellants are liable for the accuracy-related penalties proposed for 2011, 2012, 2013 and 2014.

FTB has determined that appellants are liable for accuracy-related penalties under R&TC section 19164, which generally incorporates the provisions of IRC section 6662, for the years 2011 through 2014. The basis for FTB's determination is that the deficiencies for these years constitute "substantial understatements" of tax. (See IRC, § 6662(d).) For an individual taxpayer, an understatement constitutes a "substantial understatement" that is potentially subject to the penalty if it exceeds the greater of $5,000 or 10 percent of the tax required to be shown on the return. (IRC, § 6662(d)(1)(A).) The deficiencies proposed in this matter clearly meet that threshold.

Appellants contend, however, that they come within the exception to the penalty contained in IRC section 6664(c)(1), which provides that "[n]o penalty shall be imposed under [IRC] section 6662 … with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion."[16] Such a determination is made on a case-by-case basis, taking into account all the pertinent facts and circumstances. (Treas. Reg. § 1.6664-4(b).)

> Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer....... Reliance on … the advice of a professional tax advisor … does not necessarily demonstrate reasonable cause and good faith.

(Treas. Reg. § 1.6664-4(b)(1); see also *Neonatology Associates, P.A. v. Commissioner* (2000) 115 T.C. 43, 99, affd. (3d Cir. 2002) 299 F.3d 221; *Remy v. Commissioner*, T.C. Memo. 1997-72.) A taxpayer who claims reliance on a professional tax advisor must show that: (1) the tax preparer was a competent professional who had sufficient expertise to justify reliance; (2) the tax preparer was supplied with necessary and accurate information; and (3) the taxpayer actually relied in good faith on the advice. (*Recovery Group, Inc. v Commissioner,* T.C. Memo. 2010-76.) Appellants have not shown that they meet these criteria.

Appellants have not satisfied their burden of establishing that they relied in good faith upon the returns prepared by Ms. Samson. Despite appellants' lack of familiarity with U.S. tax

[16] Although IRC section 6662 contains several other defenses to the penalty, appellants do not contend that any of those defenses are applicable here.

law, they were not uneducated people. They should have known, or at least suspected, that the returns prepared by Ms. Samson were "too good to be true." In contrast to their prior years' tax returns, the returns prepared by Ms. Samson generated refunds of *virtually all the taxes they had paid for six straight years*. Yet they did not investigate whether Ms. Samson was qualified and competent to prepare their returns;[17] they simply relied upon the fact that a friend and coworker had given her a good recommendation. Ms. Samson's lack of competency should have become apparent after almost three years passed and she still had not prepared a return. And her lack of competency should have become further apparent when she failed to sign the returns as preparer. Moreover, Ms. Samson was not an independent tax advisor; she had a clear conflict of interest in that she was going to receive 20 percent of whatever refunds she was able to generate for appellants. "When an adviser profits from a tax scheme, such as when the adviser is paid based on the percentage of taxes saved, the terms of compensation create a conflict of interest. … When a plaintiff's adviser has an economic interest in the transaction, … that circumstance weighs against the taxpayer's ability to establish a defense of reasonable cause and good faith." (*Alpha I, L.P. v. United States* (Fed.Cl. 2010) 93 Fed.Cl. 280, 316-317 (citations omitted).)

Furthermore, no correspondence has been provided between Ms. Samson and appellants concerning any factual representations that were made by appellants or concerning any tax advice that might have been received by them. The only documentation we have before us concerning the interactions between appellants and Ms. Samson are tax returns containing bogus deductions that appellants have not attempted to defend in this proceeding.[18]

Accordingly, we find that appellants have not shown they are entitled to abatement of the accuracy-related penalties.[19]

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[17] No evidence has presented indicating that Ms. Samson was a qualified tax return preparer, or that she was even licensed and authorized to prepare returns in accordance with the requirements of state and federal law.

[18] Although appellants contend that "the fact that [appellants] incurred losses on two pieces of real property is real and unequivocal," we note that the losses claimed on the foreclosure for one of those properties has been allowed, and there is no evidence in the record as to whether, when, and in what amount appellants sustained losses on the other property.

[19] In their reply brief, appellants raised a new issue, claiming that imposing accuracy-related penalties against them is unconstitutional because the penalty constitutes an "excessive fine" within the meaning of U.S. Const., 6th Amend., and Cal. Const., art. 1, § 17, and violates the due process clauses of the U.S. and California Constitutions. However, we cannot refuse to enforce the accuracy-related penalty provision unless and until an appellate court has determined it to be unconstitutional, which has not occurred. (See Cal. Const., art. III, § 3.5(a), (b) and (c); see also Cal. Code Regs., tit. 18, § 30104(a) and (b) [precluding administrative agencies from declaring a California statute unenforceable on the basis of it being unconstitutional unless an appellate court already has

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Issue 3 - Whether appellants are liable for the late-filing penalties proposed for 2011 and 2013.

R&TC section 19131 provides that a late-filing penalty shall be imposed when a taxpayer fails to file a tax return on or before its due date, unless the taxpayer establishes that the late filing was due to reasonable cause and was not due to willful neglect. Taxpayers have until April 15th of the year following the tax year to file returns without triggering the penalty. (R&TC, § 18566.) If taxpayers file by October 15th, they receive an automatic extension and the penalty is not triggered. (Cal. Code Regs., tit. 18, § 18567.) The late-filing penalty is computed at a rate of 5 percent of the tax due for every month that the return is late, up to a maximum of 25 percent. (R&TC, § 19131(a).)

Appellants' California returns for 2011 and 2013 were filed 17 and 10 months late, respectively. Therefore, FTB proposed to assess late-filing penalties, and those penalties may be waived only if appellants sustain their burden of proving that their late filings were due to reasonable cause and not willful neglect.[20] (R&TC, § 19131; *Appeal of Scott* (82-SBE-249) 1982 WL 11906.) Appellants argue that they provided all their tax information to Ms. Samson and relied on Ms. Samson to prepare their returns and file any necessary extensions. However, taxpayers have a nondelegable duty to timely prepare and file their returns. (*United States v. Boyle* (1985) 469 U.S. 241, 252.) Accordingly, appellants' reliance on Ms. Samson to timely prepare their returns does not constitute a valid defense to the imposition of late-filing penalties.

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declared it to be unconstitutional].) We also note that both the U.S. Tax Court and the U.S. Ninth Circuit Court of Appeals have rejected arguments by taxpayers that the federal accuracy-related penalty (upon which California's accuracy-related penalty is based) constitutes an unconstitutional "excessive fine." (*Gorra v. Commissioner*, T.C. Memo. 2013-254; *Little v. Commissioner* (9th Cir. 1993) 106 F.3d 1445, 1454-1455.)

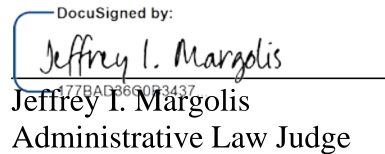
[20] Appellants do not challenge FTB's computation of the penalty amount.

HOLDINGS

1. Appellants are entitled to deduct $2,400 in 2014 as a miscellaneous itemized deduction for tax preparation fees.
2. Appellants are liable for the accuracy-related penalties proposed for 2011, 2012, 2013 and 2014.
3. Appellants are liable for the late-filing penalties proposed for the 2011 and 2013.

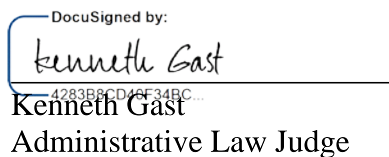
DISPOSITION

FTB's action is modified by its concession to allow a loss deduction in the amount of $156,627 for 2009 relative to the foreclosure of the Nevada property. In addition, we allow appellants a miscellaneous itemized deduction of $2,400 in 2014 for tax preparation fees.[21] In all other respects, FTB's action is sustained in full.

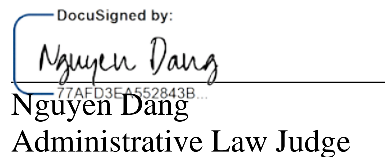


Jeffrey I. Margolis
Administrative Law Judge

We concur:



Kenneth Gast
Administrative Law Judge



Nguyen Dang
Administrative Law Judge

Date Issued: 11/23/2020

[21] This allowance will reduce both the deficiency in tax and the amount of the accuracy-related penalty for 2014.