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2021 – OTA – 213
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **R. TAYLOR AND** **J. TAYLOR**	) OTA Case No. 18093829

OPINION

Representing the Parties:

For Appellants: Lydia B. Turanchik, Esq.

For Respondent: Brad Coutinho, Tax Counsel III
Maria Brosterhous, Tax Counsel IV

For Office of Tax Appeals: Louis Gabriel, Graduate Student Assistant

J. JOHNSON, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19324, appellants R. Taylor and J. Taylor appeal an action by respondent Franchise Tax Board in denying appellants' claim for refund in the amount of $35,279.26 for the 2016 tax year.

Office of Tax Appeals Administrative Law Judges John O. Johnson, Richard Tay, and Cheryl L. Akin held an oral hearing for this matter on July 23, 2020.[1] After the hearing, additional evidence and briefing was requested, and the record was then closed on January 26, 2021, and this matter was submitted for decision.

ISSUES

1. Whether appellants have shown reasonable cause for the late payment of tax.
2. Whether appellants have established that the underpayment of estimated tax penalty (estimated tax penalty) imposed under R&TC section 19136 should be abated.

[1] The hearing was originally scheduled to occur in Cerritos, California, but was held electronically due to the COVID-19 pandemic.

FACTUAL FINDINGS

1. During the 2016 tax year, appellant-husband held an indirect minority ownership interest in the private equity fund Capital Link Fund II, LLC (the Fund).[2] On September 13, 2017, appellants' certified public accountant (CPA) received a Schedule K-1 from the Fund, which reported income substantially greater than in previous years.[3]
2. On October 15, 2017, appellants filed a joint California Resident Income Tax Return for the 2016 tax year within the extension period for filing. Appellants reported California adjusted gross income in excess of $3 million and a total tax of $355,235. After claiming tax withholdings of $3,168 and estimated tax payments of $25,800,[4] appellants' return showed tax due of $326,267, plus interest. Appellants untimely paid the amount due on October 16, 2017.
3. Appellants' tax return did not include a penalty for the late payment of tax or estimated tax penalty. Appellants enclosed with their return a Form 5805, Underpayment of Estimated Tax by Individuals and Fiduciaries, in which they requested waiver of the penalties, stating that appellants were passive investors in the Fund, appellants were not involved in the management of the Fund, and appellants did not learn of the unusually large allocation of income from the Fund until September 2017.
4. When processing appellants' return, respondent imposed a late payment penalty of $27,732.70 because appellants failed to pay the tax shown on their return by the April 15, 2017 due date.[5] Respondent also imposed an estimated tax penalty of $7,320.97.
5. Appellants requested a waiver of both penalties, asserting they were not aware of the substantial allocation of income from the Fund, and that there was no indication their

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[2] Appellant-husband held a 33 percent interest in both Centinela Investment Partners, LLC, and Centinela Group, LLC. Centinela Investment Partners held an 85 percent interest in Centinela Holdings, LLC, and Centinela Group held an 85 percent interest in Centinela Capital Partners. Together, Centinela Holdings and Centinela Capital Partners indirectly held a 1 percent interest in the Fund. The remaining interest in the Fund was owned by CalPERS. Through his positions in the Centinela group of entities, appellant-husband performed the duties of the fund manager for the Fund up until late 2012, but was not a manager of the Fund during the year at issue.

[3] In 2014, the Fund reported $631,500 in income; in 2015, $466,284; and in 2016, $10,251,585.

[4] Appellants submitted an estimated payment of $25,800 on January 15, 2017.

[5] Because April 15, 2017, fell on a Saturday, payment would have been considered timely if remitted by April 17, 2017. (Cal. Code Regs., tit. 18, § 18566.)

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distribution would differ significantly from previous years. Respondent denied the request, and appellants paid the balance due of $35,279.26.[6]

6. Appellants thereafter filed a claim for refund of the penalties and associated interest, asserting that reasonable cause existed for appellants' failure to make timely payments of tax and estimated tax. Appellants claimed that, as of the due date for payment, they lacked the means to determine their tax liability for 2016. Appellants also noted that their 2016 tax liability was significantly higher than in previous years due to an unusually large income allocation from the Fund.
7. Respondent issued a Notice of Action denying appellants' claim for refund, and this timely appeal followed.

DISCUSSION

Issue 1: Whether appellants have shown reasonable cause for the late payment of tax.

R&TC section 19001 provides that the personal income tax "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)." R&TC section 19132 provides that a late payment penalty shall be imposed when a taxpayer fails to pay the amount shown as due on the return on or before the due date of the return. Here, it is undisputed that appellants failed to timely pay tax in the amount of $326,267, and therefore the penalty was properly imposed.

The late payment penalty may be abated if a taxpayer shows that the failure to make a timely payment of tax was due to reasonable cause and not due to willful neglect. (R&TC, § 19132(a).) The taxpayer bears the burden of proving the existence of both conditions. (*Appeal of Friedman*, 2018-OTA-077P.)

To establish reasonable cause for a late payment of tax, a taxpayer must show that his or her failure to make a timely payment of the proper amount of tax occurred despite the exercise of ordinary business care and prudence, and unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Scanlon*, 2018-OTA-075P.)

Examples of circumstances that have been found *not* to constitute reasonable cause for purposes of penalty abatement include: a taxpayer's discovery of reportable income after the

[6] This amount consisted of the late payment penalty of $27,732.70 and the estimated tax penalty of $7,320.97, plus applicable interest.

original due date (*Appeal of Elixir Industries* (83-SBE-248) 1983 WL 15619), a taxpayer's difficulty in obtaining necessary information (*Appeal of Campbell* (85-SBE-112) 1985 WL 15882), and a taxpayer's difficulty in determining income with exactitude (*Appeal of Sleight*, (83-SBE-244) 1983 WL 15615; *Appeal of Avco Financial Services, Inc.* (79-SBE-084) 1979 WL 4125).

If a taxpayer asserts that they do not have the information necessary to make an accurate estimate of their tax liability, they must show the efforts made to acquire that information from the source that held it. (See *Appeal of Moren*, 2019-OTA-176P (*Moren*).)

Appellants argue that reasonable cause for the late payment of tax existed here because there was "no mechanism by which a determination could have been made by [appellants] or their advisors in April 2017 that such a large phantom income report would be issued in September 2017." At the oral hearing, appellants described the "waterfall" distribution formula contained in the 6th amended member agreement for the Fund (the Fund Agreement) and stated that this formula is ultimately what led to the unexpected "phantom income gain" which resulted in the untimely payment of tax. Appellants noted that gain had not been triggered in this way for years past, and that the gain was unforeseeable, even with a review of the documents available at the time payment of tax was due.[7]

Although appellant-husband is a sophisticated taxpayer with knowledge of the Fund's management, it is unclear whether a review of the documents and information already made available to appellants pursuant to the Fund Agreement would have alerted them to the much larger than normal gain that would be attributed to them for the 2016 tax year. It is also unclear whether the Fund manager at the time the payment of tax was due had in their possession additional information that would have notified appellants of the amount of gain for the 2016 tax year.

Appellants contend that any investigation on their part of an income adjustment prior to the due date for the payment of tax would have been futile because they were not entitled to any such tax documentation from the Fund and there was nothing that would have reflected in the

[7] Per the Fund agreement, appellant-husband was provided quarterly reports, though appellants note that these are unaudited financial statements. Appellants provided copies of these reports post-hearing, followed by briefs from both parties. While these reports show that appellants would know that they would be allocated gain in 2016, they are inconclusive as to whether appellants had any reason to expect a larger than normal allocation of gain compared to previous years.

documentation an abnormally large allocation of income prior to the payment due date.[8] Respondent contends that appellants' position of "[a]bating the penalty for a taxpayer who does not foresee an increase in taxable income based on prior years' performance is tantamount to a first-time abatement waiver . . . ,"[9] particularly when dealing with these kinds of investments. Respondent instead argues that ordinary business care and prudence requires that appellants should have made efforts to determine their tax liability with reasonable accuracy. Appellants counter that respondent's position that appellants "had an obligation to pursue the impossible" would effectively render the penalty a strict liability penalty and "read the reasonable cause exception completely out of the statute."

"The most important factor in determining reasonable cause and good faith is the extent of the taxpayer's efforts to assess his or her proper tax liability." (*Frias v. Commissioner* T.C. Memo. 2017-139, at p. *16-*17 (*Frias*).) Appellants in this appeal contend that with the financial documents already provided to them they had no way of expecting that the amount of taxable gain for the year would be so high compared to prior years. However, to show reasonable cause in such a situation, appellants "must show the efforts made to acquire that information from the source that held it, and that difficulties in obtaining the necessary information led to the delay in payment." (*Moren*, *supra*.) Ultimately, appellants' "assertion that records were difficult to obtain without any substantiation of efforts made to retrieve those records or otherwise showing that they were unobtainable is not sufficient to show reasonable cause." (*Ibid*.) Put simply, appellants cannot satisfy the requirements of reasonable cause by merely asserting that necessary tax information was difficult to obtain or that efforts to obtain such information would be futile without first actually making some modicum of effort to obtain such information.

Appellants assert that "there must have been some knowledge allocable to [appellant-husband], and an actual lack of action in response to that knowledge in order to overcome

[8] Section 9.2 of the Fund Agreement provided that "[t]he Manager shall use reasonable commercial efforts . . . to send, within one hundred eighty (180) days after the end of each Fiscal year, to each Person who was a Member at any time during such year such Company tax information as shall be necessary for the preparation by such person of its federal tax returns (including information returns)." Appellants contend that asking for any tax information from the Fund prior to the expiration of the 180-day period described in the Fund Agreement would have been an "exercise in absolute futility" and "would have been rebuffed on these grounds."

[9] While the Internal Revenue Service provides an administrative first-time abatement of the late payment penalty for taxpayers with an otherwise good payment history, no comparable administrative abatement is authorized under California law. (See, e.g., *Appeal of Scanlon*, *supra*.)

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[appellants'] reasonable cause argument." However, nonreceipt of an information return does not excuse taxpayers from their duty to report their income on their return. (*Frias*, *supra*.) Unlike in *Moren* and *Frias*, appellants were not under the impression that gain attributed to them from the Fund was nontaxable in nature as of the end of the tax year. Rather, appellants in this matter had knowledge as of the end of the tax year that they had a tax liability based on the allocation of gain from the Fund, but were simply unaware of the extent of the gain to be attributed to them. Accordingly, ordinary business care and prudence would require appellants in that scenario to make an effort to determine their tax liability with reasonable accuracy prior to the due date for the payment of tax, and that effort should include a request for documents revealing their tax liability from the owner of those documents (i.e., the Fund).

When asked at the hearing how they calculated and reported gain on prior years' returns, appellant-husband testified that he would use the available quarterly reports from the Fund to estimate what he thought would be reflected on the Schedule K-1s, and that while the previous two years resulted in penalties being imposed, they were under $1,000 and not worth contesting. Accordingly, appellants were aware that there was going to be tax due from Fund activities in 2016, and they continued to use a system of roughly estimating their gain that in the past had resulted in underpayment penalties. It was only in the year at issue when the penalties reached a certain threshold of materiality that it became worthwhile for appellants to invest the time and resources to address them. Appellants chose to base their estimate on unaudited financial reports that they have admitted are unreliable for tax matters rather than request reliable tax documents from the primary source.

Appellants argue that "taxpayers are required to exercise *ordinary* business care and prudence, not *extraordinary* business care and prudence," and that "[t]axpayers are not required to take every possible step to determine a tax liability when unforeseeable events occur." (Original italics.) But taking steps to obtain the relevant information needed to file a timely and accurate tax return is far from extraordinary.

Appellants provide a letter from the CPA firm for the relevant Centinela entities which gives a timeline of events showing how the amount of taxable income became known. Importantly, the timeline focuses on when information was provided to appellants (or their CPA), and reflects no efforts by appellants to ask for the tax information by the payment due date or at any time before it was provided by the Fund. When asked about any other contacts or

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efforts made after the close of the 2016 tax year, appellants referred back to the CPA letter and appellant-husband seemingly confirmed at the hearing that such communications originated from the Fund and not from appellants or their CPA.

Appellants detailed the history of appellant-husband's involvement as manager with the Fund, and how there was a state of hostility between the current Fund manager and appellant-husband, the former Fund manager, during the relevant period at issue. Based on this, it appears, appellants believed that any efforts exerted to obtain information from the Fund that would assist them in reasonably estimating their tax liability by the due date would be futile. However, the law still dictates that ordinary business care and prudence requires at least a modicum of effort to obtain such information. As seen in *Moren*, a claim of futility will only satisfy the requirements of ordinary business care and prudence if some timely efforts are first made. As stated in *Moren*, reasonable cause exists when an "appellant has shown that he [or she] did not have and could not have acquired the information necessary to make an estimate of his [or her] tax liability [by the due date]." Here, appellants clearly did not have the information necessary, but have not shown that they could not have acquired such information.

A taxpayer's late discovery of reportable income does not constitute reasonable cause for failing to make timely tax payments. (*Appeal of Elixir Industries*, *supra*.) Adopting a definition of reasonable cause consistent with appellants' contentions and actions on appeal, including appellants' lack of action in response to knowledge of reportable income, would incentivize taxpayers to remain ignorant of their payment requirements. Appellants contend that the primary purpose of imposing tax penalties is to encourage voluntary compliance, and they should only be imposed where there is a need to correct noncompliant purposeful behavior. But the penalty imposed here is proper under that analysis, based on appellants' failure to take any steps to timely ascertain their tax liability, especially in light of the penalties imposed for the same inaction in preceding tax years.

Indeed, as noted above, appellants used a method of estimating their income from financial statements that they admit was unreliable for tax purposes, a method which resulted in the imposition of late payment penalties in prior years, and as such they bear the risk of incurring penalties, regardless of whether those penalties are significant or not in any particular year. Appellants have not shown that they made any attempt to obtain an estimate of their income

allocation from the Fund before the payment due date, and as such have not established that their failure to timely pay the tax was due to reasonable cause.[10]

Issue 2: Whether appellants have established that the estimated tax penalty imposed under R&TC section 19136 should be abated.

California conforms to Internal Revenue Code (IRC) section 6654, and imposes an estimated tax penalty for the failure to timely make estimated income tax payments. (R&TC, § 19136 (a); IRC, § 6654.) The estimated tax penalty is similar to an interest charge and applies from the due date of the estimated tax payment until the date it is paid. (IRC, § 6654(b)(2).)

Appellants do not contest the imposition or calculation of the estimated tax penalty, but instead argue that it should be abated under IRC section 6654(e)(3)(A) and the accompanying Treasury Regulation. IRC section 6654(e)(3)(A) provides that the penalty will be abated if the government determines that "by reason of casualty, disaster, or other unusual circumstances" the imposition of the penalty would be "against equity and good conscience."

IRC section 6654(e)(3)(A) does not define "other unusual circumstances." However, under the rule of *ejusdem generis*, a Latin phrase meaning "of the same kind, class, or nature," general catch-all phrases such as this generally refer only to the same type of preceding objects specifically enumerated by the statute. (*Epic Systems Corp. v. Lewis* (2018) 138 S.Ct. 1612, 1625.) This suggests that other unusual circumstances are those events analogous to a casualty or natural disaster, and not merely a substantial increase in income.

Case law offers some additional guidance on what may or may not constitute unusual circumstances. The U.S. Tax Court has found that stock market volatility does not constitute an unusual circumstance. (*Farhoumand v. Commissioner*, T.C. Memo. 2012-131 (*Farhoumand*).) There is no authority which suggests that a substantial increase in current taxable income compared to prior years is equivalent to a casualty, disaster, or other unusual circumstance such that imposition of the estimated tax penalty would be against good equity and conscience.

Considering the foregoing, there is nothing "unusual" about the performance of the Fund such that imposition of the penalty would be against equity and good conscience. While this may have been an out-of-the-ordinary occurrence for appellants, it is not substantively different

[10] Finding no reasonable cause for the failure to timely pay taxes due, we need not address the second prong of willful neglect, which is characterized as a conscious, intentional failure or reckless indifference. (*Moren*, *supra*; *U.S. v. Boyle* (1985) 469 U.S. 241, 245.)

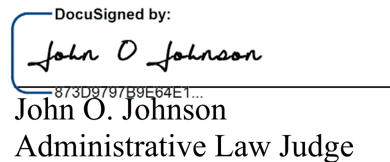
than an unexpected collapse of the stock market (*Farhoumand*, *supra*), nor is it similar to any of the above situations warranting abatement of the penalty. Furthermore, based on statements made at the hearing regarding appellants' prior filing history, and their arguments on appeal, it does not appear that the imposition of the penalty itself was unexpected; instead, it is just the rather large amount of the penalty that was unexpected. However, a recurring failure to satisfy the requirements to timely pay tax is not an "unusual circumstance" and neither is an unexpectedly large penalty. Therefore, the facts here do not provide a basis to abate the penalty pursuant to IRC section 6654.

HOLDINGS

1. Appellants have not shown reasonable cause for the late payment of tax.
2. Appellants have not established that the estimated tax penalty imposed under R&TC section 19136 should be abated.

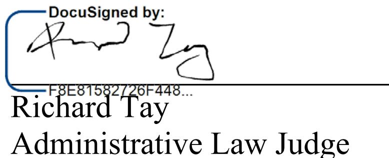
DISPOSITION

Respondent's actions are sustained.

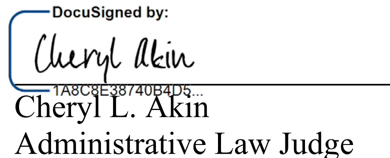


John O. Johnson
Administrative Law Judge

We concur:



Richard Tay
Administrative Law Judge



Cheryl L. Akin
Administrative Law Judge

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