OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **S. DANESHGAR AND** **L. DANESHGAR**	) OTA Case No. 20025849)))))

OPINION

Representing the Parties:

For Appellants: Melvyn E. Shiaman, CPA

For Respondent: Gi Nam, Tax Counsel

J. MARGOLIS, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, S. Daneshgar and L. Daneshgar (appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing an accuracy-related penalty of $4,184, plus interest, for their 2013 tax year.

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

ISSUE

Whether appellants are liable for an accuracy-related penalty for 2013.

FACTUAL FINDINGS

1. Appellants timely filed a 2013 California income tax return, based upon the income and deductions reported on their 2013 federal income tax return.
2. The Internal Revenue Service (IRS) commenced an audit examination of appellants' 2013 federal income tax return on July 10, 2015. The IRS audit ultimately determined that appellants understated their federal taxable income by $187,021 and, as a result, were liable for a federal income tax deficiency of $58,818 and an accuracy-related penalty of $11,763.60 on account of the deficiency being a substantial understatement of tax. An IRS Form 4549, detailing the federal changes, was issued to appellants on or about

May 4, 2016. According to the IRS transcript of account for appellants' 2013 tax year, the tax deficiency and penalty reflected in the IRS Form 4549 were assessed on July 25, 2016.

3. On or about May 15, 2016 (shortly after appellants received the IRS Form 4549), appellants filed an amended California income tax return reporting that they had agreed to the federal change to their 2013 taxable income. On their amended California return, appellants self-assessed a deficiency in their 2013 California income tax of $20,920 that was attributable to the unreported income determined by the IRS. Appellants attached to the amended return a copy of the IRS Form 4549 (reflecting the federal income adjustment, the federal tax deficiency, and the imposition of the federal accuracy-related penalty), which they had countersigned and dated May 17, 2016.
4. FTB processed appellants' amended California income tax return for 2013. Because appellants had self-assessed the California tax deficiency attributable to the IRS adjustment, there was no additional tax amount due from appellants for 2013. However, appellants did not self-assess an accuracy-related penalty. Because that penalty had been imposed by the IRS and appeared to be applicable for California tax purposes as well, FTB issued a notice of proposed assessment (NPA) proposing a California accuracy-related penalty of $4,184 (plus interest) for 2013. This amount is 20 percent of the amount of the additional California income tax appellants reported on their amended California return.
5. Appellants filed a protest from the NPA with FTB. In their protest, appellants asked that the accuracy-related penalty be abated because they had voluntarily amended their California return to report the federal change prior to being contacted by FTB. Appellants also claimed the penalty was "excessive" and alleged that "over a period of the last 35 years their record has been devoid of any irregularities and they have cooperated with all government agencies, including [FTB]."
6. FTB denied the protest and issued a Notice of Action (NOA) affirming the NPA.
7. Appellants filed this timely appeal from the NOA. In it, appellants essentially restate the arguments they had raised in their protest.

DISCUSSION

R&TC section 18622(a) requires California taxpayers to report any IRS changes to their income, deductions, penalties, credits, or tax within six months of those changes becoming final. A proposed FTB assessment based upon a final federal determination is presumed to be correct, and a taxpayer bears the burden of proving that FTB's determination is erroneous. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Gorin*, 2020-OTA-018P.)

Here, the IRS examined appellants' 2013 federal income tax return and determined that appellants underreported their income by $187,021. Accordingly, the IRS assessed a $58,818 understatement in appellants' federal income tax liability and imposed an accuracy-related penalty of $11,763.60 on account of the tax underpayment having been a "substantial understatement" within the meaning of Internal Revenue Code (IRC) section 6662. Appellants agreed to the federal determination by executing an IRS Form 4549 and they paid the amount due to the IRS.

Appellants provided FTB with notice of the IRS change to their 2013 income by filing an amended California income tax return for 2013.[1] Appellants attached to their amended return the IRS Form 4549 reflecting the IRS's determination. In the amended return, appellants agreed to the $20,920 increase in their California income tax liability resulting from the federal change to their income. Appellants did not, however, agree to the imposition of an accuracy-related penalty on the amount due.

FTB accepted appellants' amended return and issued appellants an NPA proposing to assess an accuracy-related penalty of $4,184 for 2013. The penalty amount is 20 percent of the California tax understatement (20% x $20,920 = $4,184). Appellants filed a protest from the NPA and, after it was denied, they filed this appeal.

On appeal, appellants do *not* contend that they had "substantial authority" for omitting the income at issue from their return.[2] Instead, appellants contend that the California accuracy-related penalty should not be imposed because they voluntarily filed their amended California

[1] Appellants' notification of the federal changes was provided shortly *before* the federal change was finalized (i.e., assessed, see R&TC section 18622(d)), but that is immaterial for purposes of our analysis.

[2] See IRC section 6662(d)(2)(B)(i), which provides that the amount of the understatement subject to the penalty will be reduced "if there is or was substantial authority" for the taxpayer's treatment of the adjusted item.

return reporting before being contacted by FTB.[3] Appellants also claim that the penalty should be abated or reduced because the amount of the penalty is "excessive."

California's accuracy-related penalty expressly provides that it "shall be determined in accordance with Section 6662 of the Internal Revenue Code, relating to imposition of accuracy-related penalty on underpayments, except as otherwise provided." (R&TC, § 19164(a)(1)(A).) Thus, we look primarily to IRC section 6662 and the regulations thereunder[4] to analyze whether FTB's proposed penalty determination is proper and whether appellants have asserted a valid penalty defense. We also look to IRC section 6664 and the regulations thereunder, which contain definitions and special rules relating to the imposition and computation of the accuracy-related penalty.[5]

Under IRC section 6662(b)(2), a 20 percent accuracy-related penalty is imposed on any "underpayment" of tax that is attributable to a "substantial understatement of income tax." An "understatement" of tax is defined as excess of the amount of tax required to be shown on the tax

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[3] IRC section 6662(d)(2)(B)(ii) provides that the accuracy-related penalty for substantial understatement will not apply to any portion of an understatement for which the taxpayer made an "adequate disclosure" of the relevant facts affecting the adjusted item's tax treatment on their return or on a statement attached to the return, so long as the taxpayer had a reasonable basis for the tax treatment claimed on the return. Appellants do not contend that they had a reasonable basis for the tax position taken or that they made an adequate disclosure of the disputed item on their originally filed return. Although an adequate disclosure also may be made on a qualified amended return (see Treas. Reg. § 1.6662-4(a)), we conclude below that appellants' amended California return did not constitute a qualified amended return. Hence, appellants did not make an adequate disclosure that would negate the accuracy-related penalty.

[4] Because California law incorporates the provisions of IRC section 6662, we also apply the Treasury Regulations promulgated thereunder, as required by R&TC section 17024.5(d), which provides as follows:

> When applying the Internal Revenue Code for purposes of this part, regulations promulgated in final form or issued as temporary regulations by "the secretary" shall be applicable as regulations under this part to the extent that they do not conflict with this part or with regulations issued by the Franchise Tax Board.

Furthermore, Regulation section 19503 of title 18 of the California Code of Regulations provides as follows:

> In the absence of regulations of the Franchise Tax Board and unless otherwise specifically provided, in cases where the Personal Income Tax Law or the Corporation Tax Law conform to the Internal Revenue Code, regulations under the Internal Revenue Code shall, insofar as possible, govern the interpretation of conforming state statutes, with due account for state terminology, state effective dates, and other obvious differences between state and federal law pertaining to, but not limited to, such matters as tax rates, taxable years, jurisdiction, and cross-references to other related statutes and regulations.

[5] California generally conforms to the provisions of IRC section 6664 and the Treasury Regulations thereunder. (R&TC 19164(d); Code Cal. Regs., tit. 18, § 19503.)

return for the taxable year, over the amount of tax imposed which is shown on the return, reduced by any rebate. (IRC, § 6662(d)(2)(A).) For individual taxpayers, an "understatement" constitutes a "substantial understatement" if the amount of the understatement exceeds the greater of $5,000, or 10 percent of the tax required to be shown on the return. (IRC, § 6662(d)(1)(A).) Because appellants' corrected California tax liability (i.e., the tax required to be shown on the return) for 2013 was $65,272, yet appellants only reported a tax liability of $44,352 on their originally filed return, there was a substantial understatement of tax of $20,920 for 2013.

Our task, however, does not end here. The accuracy-related penalty for a substantial understatement only applies to the portion of the underpayment of tax that is attributable to the substantial understatement of tax. The term "underpayment" is defined in IRC section 6664(a),[6] and because the definition there is substantially the same as the definition of a tax "understatement" in IRC section 6662(d)(2)(A), the amount of the underpayment and the amount of the understatement are typically the same. But this is not always the case. Treasury Regulation section 1.6664-2(c)(2) applies and provides that, in determining the amount of the tax underpayment, the tax amount shown on the return includes not only the amount shown on the taxpayer's originally filed return, but also any additional tax reported on a "qualified amended return" (unless the additional tax is attributable to a "fraudulent position" taken on the original return).[7] As relevant here, Treasury Regulation section 1.6664-2(c)(3) defines a "qualified amended return" as follows:

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[6] IRC section 6664(a) provides, in pertinent part, as follows:

> (a) Underpayment. For purposes of this part, the term "underpayment" means the amount by which any tax imposed by this title exceeds the excess of—
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> (1) the sum of—
>
> (A) the amount shown as the tax by the taxpayer on his return, plus
>
> (B) amounts not so shown previously assessed (or collected without assessment), over
>
> (2) the amount of rebates made.
>
> …

[7] Although FTB has promulgated a California-only regulation under R&TC section 19164 that contains certain limited exceptions to imposition of the accuracy-related penalty for California tax purposes, that regulation does not address what constitutes a qualified amended return. Therefore, Treasury Regulation section 1.6664-2(c)(3), which defines what constitutes a qualified amended return, is applicable for California tax purposes. (See generally Code Cal. Regs., tit. 18, § 19503.)

(3) Qualified amended return defined—

(i) General rule. A qualified amended return is an amended return, or a timely request for an administrative adjustment under [IRC] section 6227, filed after the due date of the return for the taxable year (determined with regard to extensions of time to file) and before the earliest of—

(A) The date the taxpayer is first contacted by the [IRS] concerning any examination (including a criminal investigation) with respect to the return ….

If appellants' amended California return reporting the IRS income adjustment constitutes a qualified amended return, then there is no tax underpayment to which FTB's proposed accuracy-related penalty may attach because appellants' amended return reported the corrected tax amount due. But if appellants' amended return does not constitute a qualified amended return, then the filing of that return, even though "voluntary,"[8] does not protect appellants from imposition of the penalty. Accordingly, we must decide whether appellants' amended return constitutes a qualified amended return.

Under Treasury Regulation section 1.6664-2(c)(3), an amended return must be filed *before* the taxpayer is first contacted *by the IRS* concerning any examination of the taxpayer's return for the period at issue in order to constitute a "qualified amended return." (Treas. Reg. § 1.6664-2(c)(3)(i)(A).) However, in applying this regulation, we must account for the fact that it was designed to apply to the IRS and federal taxation, not to California income taxes administered by FTB. R&TC section 17024.5(h)(7) requires that, for purposes of the Personal Income Tax Law, in applying any section of the IRC or any applicable regulation thereunder, "[d]ue account shall be made for differences in federal and state terminology, effective dates, substitution of 'Franchise Tax Board' for 'secretary' when appropriate, and other obvious differences." (See also Cal. Code Regs., tit. 18, § 19503.)

Thus, we must decide how to properly account for the differences in terminology and other obvious differences in applying the definition of "qualified amended return" contained in Treasury Regulation section 1.6664-2(c)(3)(i)(A) for California tax purposes. If we were to simply substitute "FTB" for "IRS" in Treasury Regulation section 1.6664-2(c)(3)(i)(A) so that it would define a qualified amended return for California tax purposes as one that is filed before

[8] Although appellants' filing of an amended return was voluntary in the sense that it was filed without prompting by FTB, appellants were legally obligated to report the federal change within six months of the date it became final. (See R&TC, § 18622(a).)

the date the taxpayer is "first contacted by [FTB] … concerning any examination … with respect to the return," then appellants' amended return would constitute a qualified amended return. FTB contends, however, that we must take into account two factors: (1) that California tax returns generally are based on the information set forth on the federal return for the same period; and (2) that taxpayers are legally obligated to report to FTB any changes made to their income by the IRS. Taking these factors into account, FTB argues that: "As applied to California's accuracy-related penalty, a determination on whether an amended return is a [qualified amended return] turns on whether it was filed *before* the taxpayer is contacted by *either* the IRS *or* the FTB regarding an audit of the return." (Italics added.) FTB adds that: "[T]he statute [R&TC section 18622(a)] does not state that the filing of an amended return that reports the federal changes qualifies as a [qualified amended return] or that it absolves the taxpayer from being assessed the accuracy-related penalty."

The issue before us is one of first impression.[9] In determining how to apply the definition of a qualified amended return contained in Treasury Regulation section 1.6664-2(c)(3)(i)(A) for California tax purposes, we find it appropriate to take into account the policy and purpose underlying the federal qualified amended return rule. That rule appears to have been designed to encourage voluntary compliance with the tax laws by incentivizing taxpayers to come forward and voluntarily correct errors on their returns without prompting by the taxing authority; it prohibits the IRS from imposing an accuracy-related penalty when a taxpayer corrects the error(s) in the federal return before being contacted regarding an examination of that return. But once a California taxpayer is notified of the commencement of a federal examination of their federal return, a taxpayer filing an amended California return to report federal changes (or potential federal changes) is no longer amending that return unprompted. There is no need to incentivize the taxpayer to report the federal adjustment because the outcome of the federal audit inevitably will be reported to FTB, either by the taxpayer pursuant to the requirements of R&TC section 18622, or by the regular exchanges of information between the IRS and FTB pursuant to IRC section 6103(d). Furthermore, to interpret the qualified amended return definition so as to permit a taxpayer to avoid the imposition of a California accuracy-related penalty for reporting a

[9] FTB does refer to a decision by our predecessor, the State Board of Equalization, which held that an amended return filed after an IRS audit adjustment did not constitute a qualified amended return. (See *Appeal of Freedman* (Dec 18, 2012) 2012 WL 7809513.) However, that decision is nonprecedential, and it applied Treasury Regulation section 1.6664-2(c)(2) without discussing the impact of R&TC section 17024.5(h)(7), which requires us to account for differences in federal and state terminology.

federal audit adjustment would be inconsistent with R&TC section 19164(a)(1)(A), which provides that the accuracy-related penalty "shall be imposed [and] determined in accordance with Section 6662 of the Internal Revenue Code." Here, the IRS already has determined that a penalty under IRC section 6662 applies, and appellants agreed to imposition of that penalty by signing IRS Form 4549. Treating appellants' amended return reporting this federal determination as a qualified amended return for California tax purposes would cause us to diverge from federal law—and contravene R&TC section 19164(a)(1)(A)—by relieving appellants from liability for a California substantial understatement penalty that the IRS and appellants have agreed was due under IRC section 6662. It would also be inconsistent with R&TC section 18622, which has been interpreted to mean that a federal audit determination, including federal tax penalties that apply for state tax purposes, is presumed to be correct.

Accordingly, we agree with FTB and hold that where, as here, a taxpayer files an amended California return reporting additional tax after the date the taxpayer is first contacted by *either* the IRS *or* FTB concerning an examination of the return for the period at issue, the amended return will not constitute a qualified amended return for California tax purposes.[10] As a result, the amount of tax reported on such an amended return will not reduce the amount of the tax underpayment that is subject to the California accuracy-related penalty.

Finally, appellants contend that the penalty is "excessive."[11] We have no authority to adjust the amount of the accuracy-related penalty. The California Legislature has conformed to the terms of the federal accuracy-related penalty, which sets the amount of the penalty at 20 percent of the substantial understatement. Accordingly, we uphold the penalty in the amount that is required by statute.

[10] This appeal does not involve a situation where the taxpayer's amended return reported California-only adjustments that were *not* potentially the subject of a previously issued notice of a federal tax examination. Whether such a return may constitute a qualified amended return for California tax purposes, even though filed after a taxpayer is issued a notice of federal tax examination, is not at issue in this appeal.

[11] Appellants, however, do not contend that the penalty computation was incorrect.

HOLDING

Appellants are liable for the accuracy-related penalty for 2013.

DISPOSITION

FTB's determination is sustained in full.

DocuSigned by:
Jeffrey I. Margolis
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Jeffrey I. Margolis
Administrative Law Judge

We concur:

DocuSigned by:
Josh Aldrich
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DocuSigned by:
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