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OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Consolidated Appeals of: **S. KWON;** **J. KWON;** **Y. CHUN; AND** **N. MYUNG AND** **H. KWON**	) OTA Case Nos. 18011810, 18011811, 18011812) & 18011813)))))

OPINION

Representing the Parties:

For Appellants: Andrew S. Je, CPA

For Respondent: Ciro Immordino, Assistant Chief Counsel[1]

C. AKIN, Administrative Law Judge: These consolidated appeals are made pursuant to section 19045 of the Revenue and Taxation Code (R&TC) from the actions of respondent Franchise Tax Board (FTB) proposing additional tax and penalties against S. Kwon, J. Kwon, Y. Chun, N. Myung, and H. Kwon (collectively, appellants). For appellant S. Kwon, FTB proposed additional tax of $93,448 and a late-filing penalty of $23,362 for the 2003 tax year and additional tax of $55,869 for the 2005 tax year. For appellant J. Kwon, FTB proposed additional tax of $97,722 and $56,290 for the 2003 and 2005 tax years, respectively. For appellant Y. Chun, FTB proposed additional tax of $96,257 for the 2003 tax year and additional tax of $59,667 and a late-filing penalty of $14,916.75 for the 2005 tax year. For appellants N. Myung and H. Kwon,[2] FTB proposed additional tax of $103,112 and $110,893 for the 2003 and 2005 tax years, respectively.

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

[1] Richard Tay, Tax Counsel III, wrote the Amended Opening, Additional Briefs and Response to Appellants' Additional Brief. Richard Tay and Ciro Immordino jointly wrote FTB's Reply Brief.

[2] Appellants N. Myung and H. Kwon were married and filed joint tax returns for the 2003 and 2005 tax years.

ISSUES

1. Whether appellants have demonstrated error in FTB's determination that La Habra Galleria, LLC (Galleria) was, in substance, the purchaser of the commercial property located in La Habra, California (the Galleria Property).
2. Whether appellants have demonstrated error in FTB's determination that Westridge Golf, Inc. (Westridge) distributed an interest in appreciated property to appellant N. Myung.
3. If Westridge distributed an interest in appreciated property, whether appellants have demonstrated error in FTB's determination of Westridge's basis in the distributed property or the resulting pass-through gains to appellants.
4. Whether appellants S. Kwon and Y. Chun have shown reasonable cause for abatement of the late-filing penalties.

FACTUAL FINDINGS

Galleria Transaction

1. In 1999, appellants S. Kwon, J. Kwon, Y. Chun, and N. Myung, organized KMC, LLC (KMC), a California limited liability company, for purposes of purchasing and operating a shopping center. Appellants S. Kwon, J. Kwon,[3] Y. Chun, and N. Myung[4] each held a 25 percent membership interest in KMC.
2. In June of 1999, KMC paid total consideration of $3,050,000 for two parcels of land in Los Angeles, California: hereinafter Parcel 1 and Parcel 2. The purchase price was allocated 32.35 percent to Parcel 1 and 67.65 percent to Parcel 2.
3. KMC developed and operated Parcel 2 as a small shopping center until 2003.
4. In the early part of 2003, KMC (or appellants) identified the Galleria Property as a property KMC (or appellants) believed would be suitable for development. At the time, KMC also decided to sell Parcel 2 which would provide part of the funds necessary to purchase the Galleria Property.

[3] Appellant J. Kwon held her 25 percent membership interest in KMC with her husband at the time, CC. Because CC is not a party to this appeal, he will be referred to by his initials only.

[4] Appellant N. Myung held his 25 percent membership interest in KMC with his wife at the time, appellant H. Kwon.

5. Since KMC, alone, would not be able to obtain the necessary financing required to purchase the Galleria Property, KMC decided to acquire the Galleria Property with three additional investors: CC, BK, and DL.[5]
6. KMC sold Parcel 2 on April 23, 2003, for $7,300,000.
7. To defer gain from the sale of Parcel 2, KMC entered into an Internal Revenue Code (IRC) section 1031 exchange agreement with North American Exchange Company (Exchange Company) as its qualified intermediary. KMC deposited the proceeds from the sale of Parcel 2 with Exchange Company.
8. On May 20, 2003, KMC identified the Galleria Property as the replacement property.
9. As part of a plan to acquire the Galleria Property, appellants, and the three additional investors, CC, BK, and DL, created a new entity: Galleria, a California LLC. The articles of organization for Galleria were dated July 2, 2003, and were filed with the California Secretary of State on August 1, 2003.
10. Between July 23, 2003, and July 30, 2003, funds totaling over $2,000,000 were deposited to Galleria's checking account at Nara Bank.
11. The Operating Agreement for Galleria was also dated August 1, 2003, and was signed by S. Kwon,[6] J. Kwon, Y. Chun, and N. Myung (the four members in KMC) and CC, BK, and DL (the three additional investors) as members.[7]
12. The Operating Agreement, as executed on August 1, 2003, included a Schedule of Members and Contributions to Capital which set forth the following contributions to and membership percentage interests in Galleria:

Member	Capital Contribution	Membership Percentage
CC	$925,000	14 percent
J. Kwon	$925,000	14 percent
Y. Chun	$925,000	14 percent
S. Kwon	$925,000	14 percent

[5] These three additional investors are not parties to this appeal and will be referred to by their initials only.

[6] S. Kwon uses the name S. Chun in this Operating Agreement. Records in the appeal file indicate that S. Chun and S. Kwon share the same taxpayer identification number and are in fact the same individual. In order to avoid confusion and because S. Kwon is the name used to file this appeal, the name S. Kwon will be used throughout this opinion.

[7] The operating agreement was also signed by SL, DL's wife.

N. Myung	$925,000	14 percent
DL	$500,000	7.5 percent
SL	$500,000	7.5 percent[8]
BK	$990,000	15 percent
TOTAL	$6,615,000	100 percent

13. At some point following the executing of the Operating Agreement on August 1, 2003, KMC was substituted for appellants J. Kwon, Y. Chun, S. Kwon, and N. Myung as a member in Galleria. Although an amendment to the Schedule of Members and Contributions to Capital is not included in the appeal record,[9] the Certificates of Interest, which themselves are evidence of membership in the LLC, reflected the following members and percentage interests in Galleria as of August 10, 2003: KMC (56 percent), CC (14 percent), BK (15 percent), and DL and SL as joint tenants (15 percent).
14. On August 7, 2003, funds of $2,000,000 were wired directly from Galleria's checking account at Nara Bank to an escrow account for purchase of the Galleria Property.
15. A purchase agreement between the seller and KMC, CC, BK, and DL and SL (as joint tenants) as buyers for the Galleria Property (Purchase Agreement) was executed sometime in August 2003.[10] Section 2 of the Purchase Agreement provided for a purchase price of $16,000,000, adjusted as provided in Section 2(a).
16. Section 2(a) of the Purchase Agreement expressly referred to a modification letter dated August 12, 2003, (Modification Letter) and noted that the seller was paid a $100,000 modification fee:

[8] DL and SL were married and together acquired a 15 percent interest in Galleria as joint tenants.

[9] The Schedule of Members and Contributions to Capital provides, "Any changes in ownership of LLC interests from the above will be indicated on amendments to this [schedule] and signed by the parties to this agreement." While a document is attached to the Schedule of Members and Contributions of Capital, the attached document simply provided that the vesting of the Galleria Property (not Galleria, the LLC) was "now to be" in KMC, CC, BK, and DL and SL joint tenants, all as tenants-in-common. It was not labeled as an amendment to the schedule, did not revise or address the ownership in Galleria (the LLC as opposed to the Galleria Property), and was not signed by the parties to the Galleria Operating Agreement. As such, this document does not operate as an amendment to Schedule of Members and Contributions to Capital.

[10] The Purchase Agreement stated, "AGREEMENT made this_____day of August 2003," with the actual date left blank.

> Prior to the date hereof, Buyer has deposited an amount equal to $2,000,000[11] with Fidelity National Title Insurance Company (the "Title Company"), as escrow agent ("Escrowee"), of which (i) $100,000 was disbursed to Seller as a modification fee in accordance with that certain letter agreement dated as of August 12, 2003 by and among Buyer, NCC Fox Company and Escrowee. . .

17. Section 27 of the Purchase Agreement also noted the existence of a prior nonbinding written "draft agreement" for purchase of the Galleria Property and that the original buyer set forth in the prior nonbinding written "draft agreement" was Galleria:

> The parties hereto acknowledge and agree that that certain draft agreement of sale by and between Seller and [Galleria], as Original Buyer, and executed by Original Buyer, was never executed by Seller and the terms, conditions and provisions of such agreement were never effective or binding upon either party.

18. To fund a portion of the purchase price, KMC, CC, BK, and DL and SL obtained a $10,400,000 loan from Nara Bank. The promissory note for the loan listed a loan date of August 18, 2003.
19. Escrow for purchase of the Galleria Property closed on August 29, 2003, and the deed for the purchase was recorded on September 4, 2003.
20. Pursuant to the terms of the Purchase Agreement, KMC, CC, BK, and DL received undivided tenant-in-common (TIC) interests in the Galleria Property in the following percentages: KMC (56 percent), CC (14 percent), BK (15 percent), and DL and SL, as joint tenants (15 percent).
21. Subsequent to the closing, KMC, CC, BK, and DL and SL contributed their respective undivided TIC interests in the Galleria Property to Galleria.
22. During the 2003 tax year, the business expenses associated with the holding of the Galleria Property were paid out of Galleria's checking accounts. These business expenses include development-related expenses such as civil engineering fees and legal fees; and operating expenses such as repairs, landscaping, water, property insurance, alarm installation and monthly monitoring fees, and interest on the purchase loan made

[11] While the Purchase Agreement states that Buyer (defined as KMC, CC, BK, and DL and SL) has deposited $2,000,000 into the escrow account, as noted in Finding of Fact number 14 above, these funds were actually deposited to the escrow account by Galleria on August 7, 2003.

by Nara Bank. It also includes expenses related to the acquisition of the Galleria Property such as an appraisal fee, an exchange fee, and broker commissions.

23. Galleria held the Gallery Property until April 28, 2005, when it sold the Galleria Property for $17,900,000.

Golf Course Transaction

24. Westridge was organized in California as a C corporation in 2002.
25. Westridge's initial shareholders were appellants S. Kwon, J. Kwon, Y. Chun, and N. Myung, with each owning 25,000 shares (25 percent) of Westridge's total stock.
26. In 2002, Westridge acquired property that included a golf course, clubhouse, driving range, and banquet room located in La Habra, California (the Golf Course Property).
27. Both the Buyer's/Borrower's Settlement Statement and Seller's Settlement Statement for purchase of the Golf Course Property listed a purchase price of $14,850,000 and the buyers as Westridge and a qualified intermediary on behalf of "Chapman Invest."[12] The Buyer's/Borrower's Settlement Statement indicated that $3,085,162 of the funds for the purchase of the Golf Course Property were received from "BUYER'S 1031 EXCHANGE."
28. Effective January 1, 2004, Westridge made an election to be treated as an S corporation.
29. On October 18, 2005, Westridge transferred a 25 percent undivided TIC interest in the Golf Course Property to appellant N. Myung. This transfer is evidenced by a grant deed executed by appellant N. Myung and Westridge, which was recorded in the Orange County Recorder's Office on October 18, 2005.
30. Shortly after Westridge transferred the 25 percent undivided TIC interest in the Golf Course Property to appellant N. Myung, appellant N. Myung sold his 25 percent undivided TIC interest in the Golf Course Property to KMC for $5,075,000. Both the Buyer's and Seller's Settlement Statements for the sale indicate the 25 percent undivided TIC interest in the Golf Course Property was purchased from appellant

[12] Appellants have not explained the facts behind the joint acquisition of the Golf Course Property by Westridge and "Chapman Invest," the relationship between Westridge and "Chapman Invest," including whether or not "Chapman Invest" is a disregarded entity wholly owned by Westridge, what percentage of the Golf Course Property was acquired by each buyer, the IRC section 1031 exchange performed by "Chapman Invest," and (if "Chapman Invest" is not a disregarded entity wholly owned by Westridge) when and how Westridge acquired the remaining interest in the Golf Course Property from "Chapman Invest."

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N. Myung by RPM Investments, Inc. as a qualified intermediary for KMC on October 21, 2005, fo$5,075,000. This transfer is also evidenced by a grant deed recorded in the Orange County Recorder's Office on October 21, 2005.

31. On its Schedule D-1, Sale of Business Property, filed with its 2005 return, Westridge reported the sale of a "Building." Westridge reported a gross sales price of $5,075,000, basis of $3,719,307, and accumulated depreciation of $236,271, resulting in total gain of $1,589,964.

<u>FTB Audit and Protest, and Appeal to the Office of Tax Appeals</u>

32. FTB audited KMC's 2003 tax return and Westridge's 2005 tax return.
33. With respect to the Galleria transaction, FTB disallowed KMC's IRC section 1031 exchange treatment of Parcel 2 for the applicable TIC interest in the Galleria Property on the basis that in substance Galleria, and not KMC, was the purchaser of the Galleria Property. FTB determined that, in substance, like-kind property was not acquired by KMC in the attempted IRC section 1031 exchange during the 2003 tax year.
34. With respect to the Golf Course Transaction, FTB determined that: (i) appellant N. Myung received a distribution of property in the 2005 tax year; (ii) Westridge's gain from the distribution flowed from Westridge to all its shareholders (i.e., appellants); and (iii) Westridge was subject to a built-in gains (BIG) tax gain from the distribution.[13]
35. FTB issued Notices of Proposed Assessment (NPAs) to appellants for the 2003 and 2005 tax years which appellants timely protested.
36. After FTB issued Notices of Action affirming the NPAs, appellants filed timely appeals, which have been consolidated.

[13] Because Westridge is not a party to this appeal, the issue of Westridge's BIG tax is not before us in this appeal except to the extent it impacts appellants' pass-through gain from Westridge.

DISCUSSION

Issue 1: Whether appellants have demonstrated error in FTB's determination that Galleria was, in substance, the purchaser of the Galleria Property.

Burden of Proof

FTB's determination of tax is presumed to be correct, and a taxpayer has the burden of proving error. (*Appeal of GEF Operating, Inc,* 2020-OTA-057P.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid*.) A taxpayer's failure to produce evidence that is within the taxpayer's control gives rise to a presumption that such evidence is unfavorable to the taxpayer's case. (*Appeal of Bindley*, 2019-OTA-179P; *Appeal of Cookston* (83-SBE-048) 1983 WL 15434.)

IRC section 1031

Generally, a taxpayer must recognize the entire amount of gain realized upon the sale or exchange of property unless a specific statutory provision provides otherwise. (R&TC, § 18031; IRC, §1001; Treas. Reg. §1.1002-1(a).)[14] IRC section 1031 provides that a transfer of property may qualify for nonrecognition of gain treatment if three general requirements are satisfied: (1) the taxpayer must effect an exchange (exchange requirement); (2) the exchange must involve like-kind properties (like-kind requirement); and (3) both the relinquished property and the replacement property must be held for a qualified purpose (holding requirement). (IRC, § 1031(a)(1)-(3).)[15] In addition to these requirements, only specific types of property are eligible for nonrecognition treatment, and IRC section 1031(a)(2)(D) expressly excludes partnership interests from nonrecognition treatment.

Here, KMC sold Parcel 2 on April 23, 2003, for $7,300,000, and in order to defer gain from the sale, reported that it performed an IRC section 1031 exchange. KMC entered into an exchange agreement with Exchange Company, and on May 20, 2003, identified the Galleria Property as replacement property for the exchange. Between July and August of 2003, as a part of a plan to acquire the Galleria Property, appellants and three additional investors formed and funded Galleria with over $2,000,000. An unexecuted, nonbinding "draft agreement" initially

[14] All references to the R&TC, IRC and/or Treas. Regs. in this Opinion are to those versions that were in effect for the applicable tax years at issue (i.e., 2003 or 2005 as appropriate).

[15] California conforms to IRC section 1031 at R&TC sections 18031 and 24941.

provided for the purchase of the Galleria Property by Galleria. However, that agreement was subsequently modified to replace Galleria with KMC and three additional investors, as purchasers of Galleria Property as tenants-in-common. The purchase of the Galleria Property closed on August 29, 2003, with KMC and the three additional investors each receiving TIC interests which they then transferred or contributed to Galleria.

Appellants contend that KMC acquired a TIC interest in the Galleria Property as replacement property in a valid IRC section 1031 exchange of Parcel 2 and that KMC, is therefore, entitled to defer its gain on the sale of Parcel 2 in 2003. FTB contends that, pursuant to the substance over form doctrine, Galleria was the true purchaser of the Galleria Property. Because in substance Galleria, not KMC, acquired the Galleria Property, FTB contends that KMC did not satisfy the exchange requirement as it did not acquire the property it had identified as replacement property for the exchange (i.e., the Galleria Property). Instead, FTB contends that KMC improperly exchanged its interest in Parcel 2 for an impermissible partnership interest (i.e., a membership interest in Galleria, an LLC classified as a partnership for California tax purposes).[16]

Substance Over Form Doctrine

The United States Supreme Court established the substance over form doctrine in *Gregory v. Helvering* (1939) 293 U.S. 465. If the substance of the transaction fails to satisfy the intent of the statute, then the form of the transaction that gave rise to the tax effect will be disregarded for tax purposes. (*Id.* at p. 470.) The Court further developed the substance over form doctrine in *Commissioner v. Court Holding Co.* (1945) 324 U.S. 331 (*Court Holding*) and *U.S. v Cumberland Public Service Co.* (1950) 338 U.S. 451 (*Cumberland*). In both cases, the court considered the substance over form doctrine to determine the true seller of property for tax purposes.

In *Court Holding*, a closely held corporation entered into oral negotiations for the sale of its real property. After the corporation had negotiated the sale and a down payment had been made, the shareholders were advised that if the sale was consummated as structured, the corporation would incur a large tax liability. Consequently, the day after receiving this advice,

[16] Not only is IRC section 1031 expressly inapplicable to exchanges of partnership interests per IRC section 1031(a)(2)(D), but a partnership (or membership) interest is also personal property which is not like-kind property to the real property (Parcel 2) KMC sold as relinquished property in the exchange. (See Treas. Reg., § 1.1031(a)-1(b), (c) & (d) and Treas. Reg., §1.1031(a)-2.)

the shareholders dissolved the corporation and distributed the property to themselves. The individuals then signed a written purchase agreement as owners of the property with substantially the same terms and conditions previously agreed upon by the buyer and the corporation. Within three days of the corporate liquidation, the shareholders conveyed the property to the third-party buyer who had originally negotiated the purchase from the corporation. In ruling that the sale was properly attributed to the corporation, the court stated:

> The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from the sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress. (*Id.* p. 334.)

Five years after deciding *Court Holding*, the Supreme Court reached a different result in *Cumberland*. In that case, shareholders of a closely held power company realized that the company could not compete with a new rival utility company and attempted to negotiate the sale of their stock in the company to the rival. That offer was rejected, and a counteroffer was made by the competitor to instead buy certain assets of the company. This counteroffer was rejected, based on the negative tax implications, and the shareholders instead liquidated the corporation and sold the assets to the rival. The Internal Revenue Service sought to treat the income as being received by the company under the theory that the shareholders were mere conduits for the sale.

The Court in *Cumberland* upheld the underlying United States Court of Claims' determination that the substance over form doctrine did not warrant a recharacterization of the shareholders' sale as a sale by the corporation. The Court noted, in contrast to *Court Holding*, the corporation never negotiated for the terms of the sale at issue and "that at no time did the corporation plan to make the sale [of the assets] itself." (*Cumberland, supra.* at p. 453.) The Court also determined that the company's activities and existence were genuinely ended by the dissolution and liquidation prior to the sale. The Court noted that its decision in *Court Holding* did "not mean that a corporation can be taxed even when the sale has been made by its stockholders following a genuine liquidation and dissolution." (*Id.* at p. 454.)

In *Chase v. Commissioner* (1989) 92 T.C. 874 (*Chase*), the tax court applied the substance over form doctrine to determine who was the seller of property in an attempted IRC section 1031 exchange – a partnership or the taxpayers who were partners in that partnership. The taxpayers, a husband and wife, sought to use IRC section 1031 to defer gain on the sale of an apartment building. The tax court, however, applied the substance over form doctrine and concluded that the substance of the taxpayers' purported sale of an undivided interest in the apartments was a sale by the partnership. (*Id*. at 883.) The contract for the sale of the apartments reflected the partnership as the seller. (*Id.* at 877.) The taxpayer-husband signed the contract as a general partner of the partnership, and there was no indication that the taxpayer-husband individually held any interest in the apartments. (*Ibid*.) When it was certain that the sale would close, the taxpayer-husband caused the deed for an undivided interest (which had been executed shortly after the receipt of an initial offer to purchase the apartments) to be recorded. (*Id*. at 878-879.) From the time the taxpayers received the deed to the apartments, until the date the sale was closed, the partnership, not the taxpayers, received rents and paid expenses related to the apartments. (*Ibid*.)

Reviewing the above facts, the tax court explained, "The substance over form doctrine applies where the form chosen by the parties is a fiction that fails to reflect the economic realities of the transaction." (*Chase, supra,* at p. 881, citing *Court Holding, supra,* and *Cumberland, supra*.) The tax court further explained, "Transactions, which did not vary, control, or change the flow of economic benefits, are dismissed from consideration." (*Ibid,* quoting *Higgins v. Smith* (1940) 308 U.S. 473, 476.) Applying these principles, the tax court found that in substance, the partnership rather than the taxpayers sold the property. The tax court further noted that the partnership did not complete an IRC section 1031 exchange since it did not acquire the replacement properties. Therefore, the tax court held that the taxpayers did not participate in a like-kind exchange under IRC section 1031. (*Chase, supra,* at p. 882-883.)

In the Board of Equalization's (Board) precedential opinion in *Appeal of Brookfield Manor, Inc., et al.,* (89-SBE-002) 1989 WL 37900 (*Brookfield Manor*), the Board addressed whether property in an attempted IRC section 1031 exchange was sold by appellant Brookfield Manor, Inc. (Brookfield) or by the individual appellants who were shareholders of Brookfield. In August of 1978, Brookfield negotiated with a third party to exchange its mobile home park for another unspecified piece of property and opened escrow on August 22, 1978. On

September 14, 1978, escrow was adjusted to replace Brookfield's name with the names of its shareholders and to specify the replacement property as a medical building. Brookfield then adopted a plan for liquidation on September 27, 1978, purported to distribute its mobile home park to its shareholders on or before October 28, 1978, and dissolved three days later. The properties were then exchanged on November 9, 1978.

To address who was the true seller of the relinquished property, the Board applied the principles in *Court Holding*, finding that it was factually similar. Following the principle set forth in *Court Holding*, the Board found that Brookfield took an active role in the sale and negotiated the essence of the sale prior to dissolution; the sale was conducted under substantially the same terms as negotiated by Brookfield; there was no evidence that the individual taxpayers conducted any negotiations on their own behalf with the third party; and very little time elapsed between the corporate negotiations and the final sale. Based on the foregoing, the Board determined that the sale was properly attributed to Brookfield, not the individual shareholders.

<u>Analysis of the Galleria Transaction</u>

Here, similar to the facts in *Court Holdings* and *Brookfield Manor*, only after the parties had negotiated for the purchase of the Galleria Property directly by Galleria and after Galleria paid the initial $2,000,000 deposit for the purchase, were KMC and the three additional investors substituted for Galleria as buyers. In fact these negotiations had extended so far as to: (i) result in a "draft agreement" (which was executed by Galleria as buyer but never executed by the seller), and (ii) require the payment of a substantial $100,000 modification fee to the seller in order to permit the substitution of KMC and the three additional investors for Galleria as buyers.

In considering who was the true seller of the property under the substance over form doctrine, the courts have found it important to consider whether the subsequent sale of the property by the shareholder or partner was conducted under substantially the same terms as the prior negotiation by the corporation or partnership. (See *Court Holding, supra*, at p. 333 [finding the substance over form doctrine applicable where the subsequent sales contract by the shareholders as sellers "embodied substantially the same terms and conditions as previously agreed upon"]; *Chase, supra* at p. 882 [applying the substance over form doctrine where there was "no evidence of negotiations by [the partners] on behalf of themselves concerning the terms for the disposition of the Apartments"]; *Brookfield Manor, supra* [applying the substance over form doctrine where the exchange was conducted under "substantially the same terms as originally agreed to by Brookfield and the third party"].) In other words, if the terms of the prior negotiations and the subsequent sale (or purchase) are substantially the same, then application of the substance over form doctrine may be warranted. Conversely, if the terms are substantially different, the substance over form doctrine may not be applicable. (See *Court Holding, supra*, at p. 332-333 [noting that the fifth circuit had found the corporation "called off" the sale; but the Supreme Court reversed the decision of the fifth circuit and relied on the findings of the tax court that the corporation had not abandoned the sales negotiations]; *Hines v. United States* (5th Cir. 1973) 477 F.2d 1063, 1070 [finding the substance over form doctrine not applicable where the subsequent sale was the result of "independent and active negotiations"].)

Here, appellants have failed to provide evidence demonstrating that purchase of the Galleria Property by KMC and the three additional investors as tenants-in-common under the later executed Purchase Agreement was made under substantially different terms than those agreed to in the prior negotiations between Galleria and the seller and set forth in the prior unexecuted "draft agreement." Notably, appellants have not provided a copy of the prior nonbinding written "draft agreement" between Galleria and the seller, which might have demonstrated that the terms of the prior negotiations and the subsequent Purchase Agreement were substantially different. Further, appellants have not provided copies of: (1) the August 12, 2003 Modification Letter; or (2) the agreement under which the $2,000,000 transfer was made into escrow on August 7, 2003; either of which may have clarified whether the terms of the prior negotiations between Galleria and the seller had been substantially modified.[17]

A taxpayer's failure to produce evidence that is within his or her control gives rise to a presumption that such evidence is unfavorable to his or her case. (*Appeal of Bindley, supra*; *Appeal of Cookston*, *supra*.) While appellants state that they "are not in possession" of these documents, appellants have failed to explain why these documents are not in their possession or why they cannot be obtained and made available. As such, we presume that these documents, if provided, would be unfavorable to appellants' case.

Based on the evidence presented, appellants have failed to establish that the initial purchase of the Galleria Property by Galleria was "called off" or abandoned and that subsequent

[17] On appeal, the Office of Tax Appeals (OTA) specifically requested copies of the unexecuted "draft agreement," the Modification Letter dated August 12, 2003, and the agreement under which the $2,000,000 transfer was made into escrow; however, appellants failed to provide these documents stating that they "are not in possession" of the documents requested.

purchase by KMC and the additional three investors was the result of "independent and active negotiations" by KMC and the additional three investors. Additionally, we note that very little time elapsed between the prior negotiations between the seller and Galleria as the original buyer and the subsequent execution of the Purchase Agreement providing for the purchase of the Gallery Property by KMC and the individual investors.[18] This is another factor found to be significant in determining the true seller (or buyer) of property under the substance over form doctrine. (See e.g., *Brookfield Manor, supra.* [noting that very little time elapsed between the corporate negotiations and the final sale].)

Further, while in form KMC and the additional three investors were substituted for Galleria as the buyers of the Galleria Property in the Purchase Agreement, we find it significant that Galleria continued to pay expenses associated with the purchase of the Galleria Property even after this substitution. This includes an exchange fee paid to the Exchange Company on August 28, 2003, title fees paid to Fidelity National Title on August 29, 2003, and broker commissions paid to One Properties on September 5, 2003. We further find it significant that KMC and the three additional investors failed to pay any of the operating expenses of the Galleria Property as tenant-in-common owners of the Galleria Property during the 2003 tax year. Instead, the record shows that Galleria paid all of the business and operating expenses associated with the holding of the Galleria Property during the 2003 tax year and that these payments by Galleria began immediately upon the close of the purchase of the Gallery Property on August 29, 2003.[19] This suggests that KMC and the additional three investors only held their respective TIC interests in the Galleria Property for a mere instant before immediately transferring the property to the intended owner and purchaser, Galleria.

Galleria's payment of all the operating and acquisition-related expenses associated with the Galleria Property during 2003 is inconsistent with appellants' assertion that KMC and the three additional investors acquired TIC interests in the Galleria Property in substance, as well as

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[18] While we do not know the exact timing of the prior negotiations or the date of execution of the final Purchase Agreement for the purchase of the Galleria Property by KMC and the individual investors, $2,000,000 was paid into escrow by Galleria on August 7, 2003, a modification letter substituting KMC and the three additional investors for Gallery as buyers was executed on August 12, 2003, and the purchase of the Galleria property by the new buyers, KMC and the individual investors, closed on August 29, 2003.

[19] The expenses paid directly by Galleria includes expenses associated with the holding of the property such as repairs, landscaping, water, property insurance, and alarm installation and monthly monitoring fees, and expenses related to the potential development of the property such as civil engineering fees and legal fees. They also includes the interest on the purchase loan from Nara Bank obtained by KMC and the additional three investors.

in form. "The tax consequences which arise from . . . the sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole . . . [and a] sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title." (*Court Holding, supra*, at p. 334.) While *Court Holding* dealt with a *sale* of property and the transaction at issue in this appeal is the *purchase* of property, we conclude that the analysis remains the same. Regardless of whether a transaction is a sale or purchase, in order to be respected for tax purposes, the form of the transaction must be consistent with its substance and the tax consequences which arise from the transaction are not finally to be determined solely by the means employed to transfer legal title. "The substance over form doctrine applies where the form chosen by the parties is a fiction that fails to reflect the economic realities of the transaction." (*Chase, supra,* at p. 881, citing *Court Holding, supra,* and *Cumberland, supra*.) "Transactions, which did not vary, control, or change the flow of economic benefits, are dismissed from consideration." (*Ibid,* quoting *Higgins v. Smith, supra,* at p. 476.) While in form, KMC and the three additional investors were substituted for Galleria as buyers of the Galleria Property, this substitution did not change the economic realities of the transaction. The economic realities of the transaction establish that Galleria, not KMC, was in substance the purchaser and owner of the Galleria Property.

In summary, the substance over form doctrine is applicable to transactions like these, where transfers of legal title are "mere formalities designed 'to make the transaction appear to be other than what it was,' in order to avoid tax liability." (*Court Holding, supra,* at p. 333.) The momentary acquisition of legal title to the Galleria Property by KMC and the individual investors as tenants-in-common before immediately transferring that legal title to Galleria, failed to reflect the economic realities of the transaction and, therefore must be dismissed from consideration. (*Chase, supra,* at p. 881.)

Applying the substance over form doctrine to this transaction, we conclude that, in substance, Galleria was the purchaser of the Galleria Property for tax purposes. Accordingly, we find that KMC did not acquire the Galleria Property as replacement property in its attempted IRC section 1031 exchange, and therefore, did not complete its attempted exchange of Parcel 2. Instead of acquiring the identified replacement property (i.e., the Galleria Property), KMC received an impermissible partnership/membership interest in Galleria. As such, FTB properly disallowed KMC's attempted IRC section 1031 exchange. [20]

Appellants' Alternative Argument that the Deferred Gain was Recognized in 2005

As an alternate argument, appellants contend that when the Galleria Property was subsequently sold in the 2005 tax year, KMC and its members recognized the gains previously deferred in the 2003 exchange of Parcel 2 for the Galleria Property. Appellants contend that all taxes derived from that sale in 2005 have been fully paid, such that (in appellants' understanding) even if the IRC section 1031 exchange is found to be defective, FTB would be inappropriately collecting taxes for the 2003 tax year, when the appellants already paid the applicable taxes when they filed their 2005 tax returns.

While Galleria sold the Galleria Property on April 28, 2005, for $17,900,000, we find that Galleria, KMC, and appellants did not properly recognize the deferred gain from the 2003 exchange of Parcel 2 at that time, as appellants contend. While Galleria's tax returns are not in the record, appellants' reply brief indicates that Galleria's reported an adjusted basis in the Galleria Property at the time of the sale of $16,032,865 and a gain on the sale of $1,867,135. This basis amount is consistent with the $16,000,000 purchase price of the Galleria Property, increased for purchase expenses and or improvements, and decreased by accumulated depreciation. However, Galleria's basis in the Galleria Property should have been reduced by KMC's deferred gain on the exchange of Parcel 2 for the Galleria Property.

IRC section 723[21] provides that the basis of property contributed to a partnership by a partner shall be the adjusted basis of such property to the contributing partner at the time of

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[20] Appellants cite to *Magneson v. Commissioner* (9th Cir. 1985) 735 F.2d 1490, *Bolker v. Commissioner* (9th Cir. 1985) 766 F.2d 1039, *Maloney v. Commissioner* (1989) 93 T.C. 89, and *Appeal of Rago Development Corp. et al*., (2015-SBE-001) 2015 WL 10553154 (*Rago)* to argue that the holding requirement was met with respect to the replacement property despite the transfer of ownership of the Galleria Property from KMC and the individual investors as tenants-in-common to Galleria. However, FTB does not dispute KMC's satisfaction of the holding requirement. Because the holding requirement is not at issue in this appeal, these cases will not be addressed or discussed further in this Opinion.

Additionally, to the extent that *Rago* found that the substance over form doctrine did not apply, we note that *Rago* is distinguishable from the instant appeal. In *Rago*, the appellants held the replacement property for a period of seven months before transferring the property to an LLC. During this time, the appellants as tenants-in-common, not the LLC, paid for the operating expenses of the replacement property, bore the economic risk of value depreciation and physical damage to the property, and also the benefit of any increased value. Moreover, there was no evidence that the parties in *Rago* had previously negotiated with the seller for the purchase of the replacement property directly by the LLC (instead of by the appellants as tenants-in-common) as occurred here.

[21] California conforms per R&TC section 17851.

contribution. Per KMC's form 8824, Like-Kind Exchange, included with KMC's 2003 tax return, KMC reported a deferred gain of $4,262,908 on the exchange of Parcel 2 for the Galleria Property and an adjusted basis in the like-kind property received (i.e., KMC's 56 percent TIC interest in the Galleria Property) of $4,697,092. Thus, under IRC section 723, Galleria's basis in the 56 percent TIC interest contributed to it by KMC was $4,697,092, not the full $8,960,000 purchase price attributable to KMC's 56 percent TIC interest in the Galleria Property ($16,000,000 x 0.56 = $8,960,000).[22] As such, Galleria's gain computation, which uses a basis equal to the entire $16,000,000 purchase price, understates Galleria's gain on the sale of the Gallery Property in 2005 by KMC's deferred gain of $4,262,092.

Additionally, while appellants note that Galleria had and reported a gain of $1,867,135 on the sale of the Galleria Property in 2005, per KMC's 2005 tax return, KMC reported a $750,213 loss on the sale of the Galleria Property.[23] Thus, instead of properly reporting its share of Galleria's $6,130,043[24] gain on the sale of the Galleria Property, KMC improperly reported a $750,213 loss. Similarly, the Schedule K-1s issued to appellants by KMC also reported losses which appellants then reported on their individual tax returns for the 2005 tax year.

As such, appellants have not demonstrated that they paid taxes on the deferred gain from the 2003 exchange when the Galleria Property was subsequently sold in 2005. We further note gain properly recognizable in the 2003 tax year is subject to tax in 2003, not 2005. Each taxable year stands on its own terms and must be separately considered. (See *United States v. Skelly Oil Co*. (1969) 394 U.S. 678, 684; *Pekar v. Commissioner* (1999) 113 T.C. 158, 166.) Because KMC did not perform a valid IRC section 1031 exchange in 2003, KMC must recognize gain on the sale of Parcel 2 in the 2003 tax year, as determined by FTB.

<u>Issue 2: Whether appellants have demonstrated error in FTB's determination that Westridge distributed an interest in appreciated property to appellant N. Myung</u>.

Under IRC section 311(b), when a corporation distributes appreciated property to a shareholder, the distributing corporation must recognize gain as if it had sold the property to the

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[22] $8,960,000 minus the deferred gain of $4,262,908 equals the reported basis of $4,697,092.

[23] Per KMC's California Schedule D for the 2005 tax year, KMC reported a sales price of $3,948,501, basis of $4,698,714, and a loss of $750,213 on the sale of "La Habra Galleria" on April 28, 2005.

[24] The $1,867,135 gain as computed by appellants using basis of $16,032,865, plus the additional gain of $4,262,092.

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distributee at its fair market value. (IRC, §§ 311(b); R&TC, § 24451.) The gain will pass through to the shareholders as in the case of any other corporate gain. (IRC, § 1366; R&TC, § 23800.)

On appeal, appellants argue that gain recognition is not required under IRC section 311(b) during the 2005 tax year because there was no distribution of appreciated property by Westridge to a shareholder. Instead, appellants contend that appellant N. Myung sold his Westridge shares to appellants J. Kwon and S. Kwon directly via a cross-purchase agreement. Appellants contend that the cross-purchase transaction was agreed upon orally and, therefore, there are no written agreements evidencing the cross-purchase agreement. Appellants request that OTA find that "in substance" the transaction between appellant N. Myung and appellants J. Kwon and S. Kwon was a cross-purchase of an S corporation shareholder's entire interest.

Appellants have not provided any evidence substantiating the claimed cross-purchase agreement of appellant N. Myung's stock. Further, the evidence in the appeal record supports a finding that appellant N. Myung received a distribution of property from Westridge. This evidence includes: (1) the grant deeds (recorded in the Orange County Recorder's Office) which reflect a transfer of a 25 percent TIC interest in the Golf Course Property from to Westridge to appellant N. Myung on October 18, 2005, followed by the subsequent sale of this 25 percent TIC interest by N. Myung to KMC for $5,075,000 on October 21, 2005; (2) Westridge's reporting of this transaction as a sale of business property (described as "Building") on its 2005 Schedule D-1 for $5,075,000; and (3) the remaining shareholders' equal ownership of Westridge following the transaction in question.

If there was no distribution of property by Westridge as appellant's contend, there would be no need for Westridge to report the transaction as a sale of property as it did on its 2005 tax return. Further, had appellants J. Kwon and S. Kwon directly purchased appellant N. Myung's stock in Westridge as appellants allege, they would have had higher ownership percentages in Westridge than the other remaining shareholder, appellant Y. Chun, following the purchase. However, following this transaction, the three remaining shareholder's ownership percentages in Westridge increased equally, with appellants Y. Chun, J. Kwon, and S. Kwon each owning 26.621055 percent before the transaction and 33.33 or 33.34 percent of the shares in Westridge by the end of 2006.

Finally, appellants' argument fails to address the subsequent sale of a 25 percent TIC interest in the Golf Course Property to KMC for $50,75,000 on October 21, 2005. If, in substance, there was no distribution, and J. Kwon and S. Kwon instead purchased N. Myung's shares in Westridge directly from N. Myung, as appellants assert, then, in substance, Westridge (not appellant N. Myung) continued to own the entire Golf Course Property until the subsequent sale of the 25 percent TIC interest to KMC. As such, upon the sale to KMC, Westridge (the owner in substance under appellants' theory) would still be required to recognize gain from the sale under IRC section 1001 and R&TC section 24941, which would similarly pass through to the shareholders as required by IRC section 1366 and R&TC section 23800.

The evidence in the appeal record supports FTB's determination that appellant N. Myung received a distribution of appreciated property from Westridge in 2005. While a taxpayer is free to organize its affairs as it chooses, nevertheless, once having done so, it must accept the tax consequences of its choice whether contemplated or not, and may not enjoy the benefit of some other route it might have chosen to follow but did not. (*Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134,149.) Westridge and appellants structured the transaction as a distribution of property to appellant N. Myung followed by a sale of that property by appellant N. Myung to KMC. Appellants may not recast that transaction as a direct purchase of appellant N. Myung's Westridge stock by appellants J. Kwon and S. Kwon when hindsight has provided more clarity of the tax consequences.

Issue 3: If Westridge distributed an interest in appreciated property, whether appellants have demonstrated error in FTB's determination of Westridge's basis in the distributed property or the resulting pass-through gains to appellants.

Appellants contend that if there was a distribution of appreciated property by Westridge, "the purchase price that [FTB] uses in calculating basis is clearly in error." Appellants contend that this resulted in an overstatement of Westridge's gain on the distribution, which in turn resulted in an overstatement of pass-through gain allocated to appellants as shareholders in Westridge.

Basis Calculation

Appellants contend that Westridge should be entitled to the full $14,850,000 purchase price of the Golf Course Property as its basis in the Golf Course Property. As substantiation of the claimed $14,850,000 purchase price, appellants provided both a Buyer's/Borrower's and Seller's Settlement Statement for the purchase of the Golf Course Property in 2002. While these statements reflected a purchase/sales price of $14,850,000, both the Buyer's/Borrower's and Seller's Settlement Statements listed the buyers of the Golf Course Property as Westridge AND a qualified intermediary on behalf of "Chapman Invest." Appellants have failed to provide any explanation for this acquisition of the Golf Course Property jointly by Westridge and "Chapman Invest," the relationship between Westridge and "Chapman Invest," the IRC section 1031 exchange performed by "Chapman Invest," or when and how Westridge acquired the remaining interest in the Golf Course Property from "Chapman Invest."[25] The Buyer's/Borrower's Settlement Statement also indicated that $3,085,162 of the funds used for the purchase of the Golf Course Property were received from "BUYER'S 1031 EXCHANGE."

The basis of property acquired in an IRC section 1031 exchange is equal to the basis of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss recognized by the taxpayer in exchange. (IRC, §1031(d).) Thus, with respect to the portion of the Golf Course Property that was acquired as replacement property in an IRC section 1031 exchange, Westridge's/"Chapman Invest's" basis would be equal to its basis in the property exchanged (properly adjusted for any money received or any gain or loss recognized), not cost under IRC section 1012 as appellants assert.

Because appellants failed to provide any explanation for this joint acquisition by Westridge and "Chapman Invest" or the IRC section 1031 exchange, FTB estimated Westridge's basis in the Golf Course Property using information contained in the Buyer's Escrow Statement. FTB subtracted the $3,085,162 funds which were received from "BUYER'S 1031 EXCHANGE," from the total $14,850,000 purchase price to estimate a basis of $11,764,838 for the Golf Course Property. However, because Westridge's tax returns for previous years and its corporate books both treated the Golf Course Property's basis as $11,860,232, FTB allowed the higher amount of $11,860,232 as the property's adjusted basis.[26]

[25] Assuming "Chapman Invest" is not a disregarded entity wholly owned by Westridge.

[26] Appellants also assert that the $11,860,232 used by FTB in its calculation only reflects Westridge's reported basis in the building and does not include Westridge's reported basis in land in the amount of $2,372,424. However, for the reasons discussed below, appellants have not established that their basis in the Golf Course Property is more than the amount determined by FTB.

Using $11,860,232 as the cost basis in the Golf Course Property, FTB properly revised Westridge's adjusted basis in the 25 percent TIC interest distributed to N. Myung as follows:

	100 percent	25 percent
Cost Basis:	$11,860,232	$2,965,058
Depreciation:		$ 234,271[27]
Revised Adj. Basis:		$2,730,787

FTB's determinations are generally presumed correct, and taxpayers bear the burden of proving otherwise. (*Appeal of GEF Operating, Inc., supra*.) Appellants have failed to provide any explanation of the joint acquisition of the Golf Course Property by Westridge and "Chapman Invest" or the IRC section 1031 exchange performed by "Chapman Invest" and have failed to account for this IRC section 1031 exchange in their computation of basis which uses the entire $14,850,000 purchase price. As such, appellants have failed to meet their burden of establishing error in FTB's determination of Westridge's basis in the Golf Course Property.

Calculation of Westridge's Gain and Appellants' Resulting Pass-Through Gain

Using the $2,730,787 cost basis in the 25 percent interest in the Golf Course Property, FTB made the following adjustments to Westridge's reported gain from the distribution of the 25 percent interest in the Golf Course Property in 2005:

Selling price as reported	$5,075,000
Adjusted basis as revised	($2,730,787)
Gain as revised	$2,344,213
Gain reported	$1,589,964
FTB adjustment	$754,249

The entire $1,589,964 gain reported by Westridge was allocated by Westridge to appellant N. Myung alone. Westridge's other three shareholders were not allocated any gain from the distribution of the 25 percent in the Golf Course Property per the applicable 2005 tax returns. However, IRC section 1366, as incorporated by R&TC section 23800, provides in part that an S corporation's items of income and loss are allocated pro-rata to its shareholders. Taking into account FTB's revisions to Westridge's gain from the distribution, FTB also revised the amounts of pass-through gain to appellants, Westridge's shareholders, as follows:

Pass-Through Pass-Through BIG Tax Ded.

[27] R&TC section 24916(b)(1) requires taxpayers to adjust their basis in property for depreciation deductions taken on the property to the extent allowed (but not less than the amount allowable).

Shareholder	Interest	Gain Reported	Gain as Revised	per FTB Audit[28]	Total
Y. Chun	0.26621005	$0	$624,053	$(18,781)	$605,272
S. Kwon	0.26621005	$0	$624,053	$(18,781)	$605,272
J. Kwon	0.26621005	$0	$624,053	$(18,781)	$605,272
N. Myung	0.20136986	$1,589,964	$472,054	$(14,206)	$(1,132,116)
TOTAL			$2,344,213	$(70,549)	$683,700[29]

In summary, FTB revised the computation of the gain from the distribution and deemed sale of the 25 percent interest in the Golf Course Property and reallocated the entire gain from appellant N. Myung to all of Westridge's shareholders. Appellants have not provided evidence demonstrating error with FTB's determination of gain, and we find no such evidence in the appeal record.

Appellants' Arguments Regarding Westridge's BIG[30]

Appellants also argue that FTB erred in its imposition of the BIG tax. Appellants' position with respect to the BIG is premised on their argument that because appellants J. Kwon and S. Kwon purchased N. Myung's shares of stock in Westridge pursuant to a cross-purchase agreement, there was no distribution of appreciated property by Westridge which would subject Westridge to the BIG tax during 2005.[31] Appellants do not otherwise dispute, and this Opinion therefore does not address, the application of the BIG provisions or FTB's computation of Westridge's BIG or BIG tax. As we have already concluded that Westridge distributed a 25

[28] IRC section 1366(f)(2) permits shareholders to treat the corporate BIG tax as a loss that has the same character as the gain that gave rise to the tax. FTB computed Westridge's BIG tax as $70,548 (computed by multiplying Westridge's BIG as computed by FTB of $798,055 by the California C-corporation tax rate of 8.84 percent), and therefore, permitted each shareholder/appellant a deduction (loss) equal to their pro-rata share of Westridge's $70,548 BIG tax. The $1 difference in total is due to rounding.

[29] $683,700, adjusted for the $70,549 total BIG tax deduction (loss), equals to $754,249 adjustment FTB made to Westridge's gain on the distribution of the Golf Course Property as computed above.

[30] While Westridge is not a party to this appeal, the computation of Westridge's BIG and resulting BIG tax will impact appellants' pass-through deductions (losses) for Westridge's BIG tax under IRC section 1366(f)(2).

[31] In their opening brief appellants also assert that the fair market value of the Golf Course Property at the date of the S-Corporation election was $11,438,452 based on its property tax bill for 2014, not $16,485,000 as computed and utilized by FTB. However, appellants' reply, supplemental, and additional briefs do not continue to raise this issue, and it appears that appellants have abandoned this argument. To the extent that appellants continue to maintain this argument, we note that the assessed value of the Golf Course Property per the property tax bill does not represent the fair market value of the property because California proposition 13 prevents a property's assessed value from increasing by more than one percent per year. To the extent the fair market value of the Golf Course Property appreciated by more than 1 percent per year, the property tax bill would not reflect such appreciation. Appellants have not provided any other evidence that would establish error in the $16,485,000 fair market value used by FTB in its BIG tax computations.

percent interest in the Golf Course Property to N. Myung during the 2005 tax year (which resulted in Westridge recognizing gain under IRC section 311(b) as if the property had been sold to the distributee at its fair market value), appellants have not established error in FTB's imposition of the BIG tax on Westridge or appellants' resulting pro-rata BIG tax loss deduction as permitted by IRC section 1366(f)(2).

Issue 4: Whether appellants S. Kwon and Y. Chun have shown reasonable cause for abatement of the late-filing penalties.

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 is due to reasonable cause and not due to willful neglect. When the FTB imposes a penalty, the law presumes that the penalty was imposed correctly. (*Appeal of Xie*, 2018-OTA-076P.) To overcome the presumption of correctness attached to the penalty, appellants must provide credible and competent evidence supporting a claim of reasonable cause. (*Ibid*.)

Appellants do not dispute the law or computation of the penalties. Rather, appellants argue that the abatement of the late-filing penalties is proper "given [FTB's] role in the slow administration of this case." However, appellants have not shown how any actions of FTB caused, or otherwise excuse, the late filing of appellant S. Kwon's 2003 income tax return and appellant Y. Chun's 2005 income tax return. Appellant S. Kwon's 2003 income tax return was due on April 15, 2004, and appellant Y. Chun's 2005 income tax return was due on April 15, 2006, both of which are before FTB began its examination of those tax years. Appellants S. Kwon and Y. Chun do not provide any additional argument or evidence which would establish reasonable cause for the abatement of the late-filing penalties.

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HOLDINGS

1. Appellants have not demonstrated error in FTB's determination that Galleria was, in substance, the purchaser of the Galleria Property.
2. Appellants have not demonstrated error in FTB's determination that Westridge distributed an interest in appreciated property to appellant N. Myung.
3. Appellants have not demonstrated error in FTB's determination of Westridge's basis in the distributed property or the resulting pass-through gains to appellants.
4. Appellants S. Kwon and Y. Chun failed to show reasonable cause for abatement of the late-filing penalties.

DISPOSITION

FTB's actions are sustained.

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Cheryl Akin
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Cheryl L. Akin
Administrative Law Judge

We concur:

DocuSigned by:
Huy "Mike" Le
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Huy "Mike" Le
Administrative Law Judge

DocuSigned by:
E.S.Ewing
2D8DE82EB65E4A6...
Elliott Scott Ewing
Administrative Law Judge

Date Issued: 4/14/2021