OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18011799
A. EDWARDS	)
	)
	)
	)

OPINION ON PETITION FOR REHEARING

Representing the Parties:

For Appellant: Gene Weinstein,
M&G Business Services, LLC

For Respondent: Maria Brosterhous, Tax Counsel IV

J. LAMBERT, Administrative Law Judge: On February 1, 2021, the Office of Tax Appeals (OTA) issued an Opinion in which the determination of respondent Franchise Tax Board (FTB) was modified to reflect revised California source income of $13,654.49 and to abate the demand penalty. Additionally, the Opinion held that A. Edwards's (appellant) late filing penalty be recomputed and reduced based on the revised California source income, and that FTB's action be otherwise sustained. FTB filed a timely petition for rehearing (PFR).

A rehearing may be granted where one of the following six grounds exists, and the substantial rights of the filing party are materially affected: (1) an irregularity in the appeal proceedings, that occurred prior to issuance of the Opinion and prevented fair consideration of the appeal; (2) an accident or surprise that occurred during the appeal proceedings and prior to the issuance of the Opinion, which ordinary caution could not have prevented; (3) newly discovered, relevant evidence, which the filing party could not have reasonably discovered and provided prior to issuance of the Opinion; (4) insufficient evidence to justify the Opinion; (5) the Opinion is contrary to law; or (6) an error in law in the appeals hearing or proceeding. (Cal. Code Regs., tit. 18, § 30604(a)(1)-(6).)

FTB contends that a rehearing should be granted on the grounds that the Opinion is contrary to law and that there was an irregularity in the proceedings. The question of whether the opinion is contrary to law is not one which involves a weighing of the evidence, but instead,

requires a finding that the opinion is "unsupported by any substantial evidence"; that is, the record would justify a directed verdict against the prevailing party. (*Sanchez-Corea v. Bank of America* (1985) 38 Cal.3d 892, 906.)[1] This requires a review of the opinion in a manner most favorable to the prevailing party, and an indulging of all legitimate and reasonable inferences to uphold the opinion if possible. (*Id*. at p. 907.) The question before us on a petition for rehearing does not involve examining the quality or nature of the reasoning behind OTA's opinion, but whether that opinion is valid according to the law. (*Appeal of Nassco Holdings, Inc*. (2010-SBE-001) 2010 WL 5626976.)

An irregularity in the proceedings has been defined as "any departure by the court from the due and orderly method of disposition of an action by which the substantial rights of a party have been materially affected." (See *Appeal of Graham and Smith*, 2018-OTA-154P, citing *Gay v. Torrance* (1904) 145 Cal. 144, 149.)

California Source Income

FTB argues that the Opinion is contrary to law because OTA revised FTB's determination of appellant's California source income, which reduced his tax liability, even though appellant did not file a tax return and despite the Opinion's holding that he had a filing requirement pursuant to Revenue and Taxation Code (R&TC) section 18501. FTB asserts that until a tax return has been filed, there can be no determination of a taxpayer's correct tax liability. Accordingly, FTB contends that OTA should always require the filing of tax returns by taxpayers with a filing requirement, before determining the amount of a tax liability.

FTB does not point to any legal authorities stating that OTA has the authority to require or must require appellant to file a tax return before such a revision can be made to appellant's California source income. On the contrary, the burden of proof on appellant was to prove error in FTB's determination. (See *Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514 [holding that FTB has the initial burden of showing that its assessment is reasonable and rational, after which, the burden shifts to the taxpayer to show error in the assessment].) Appellant must have shown

[1] California Code of Regulations, title 18, (Regulation) section 30604 is essentially based upon the provisions of California Civil Code of Procedure (CCP) section 657. (See *Appeal of Wilson Development, Inc.* (94-SBE-007) 1994 WL 580654 [State Board of Equalization (BOE) utilizes CCP section 657 in determining grounds for rehearing]; *Appeal of Do*, 2018-OTA-002P [OTA adopts BOE's grounds for rehearing].) Therefore, the language of CCP section 657 and case law pertaining to the operation of the statute provide guidance in interpreting the provisions contained in this regulation.

error in FTB's determination by a preponderance of evidence. (Cal. Code Regs., tit. 18, § 30219(c).) Appellant could rebut FTB's presumption of correctness by providing credible, competent, and relevant evidence. (*Appeal of GEF Operating, Inc*., 2020-OTA-057P.) The law does not require that appellant provide a tax return as a preliminary matter for OTA to determine the correct amount of appellant's California source income. OTA's only power is to determine the correct amount of the taxpayer's California income tax liability. (*Appeals of Dauberger, et al*. (82-SBE-082) 1982 WL 11759.) FTB argues that appellant should be liable for the entire assessment because he did not file a return, despite documentation showing that appellant's California source income was less than the amount determined by FTB. However, we conclude that OTA may not disregard evidence establishing a reduction in a proposed deficiency solely because appellant has not filed a tax return for the year at issue.

FTB asserts that California employs a system of voluntary taxpayer compliance, as described in the California Taxpayer Bill of Rights (TBOR), under R&TC sections 21001 through 21028. FTB argues that, by reducing appellant's liability without the filing of a return, OTA is condoning the refusal to file despite the existence of a filing requirement, thereby undermining the system of voluntary taxpayer compliance. Similarly, FTB asserted in its briefing on the underlying Opinion that "this appeal is not the appropriate forum to audit appellant and his related entities' books and records, or to apportion income." However, FTB's regulations do not require appellant to submit a tax return in order for California source income to be determined. Instead, the regulations provide that appellant may provide evidence, such as books and records, to rebut FTB's presumption and show the location of the benefit of the services for purposes of apportioning income. (Cal. Code Regs., tit. 18, § 25136-2(c)(2).)[2]

California Code of Regulations, title 18, (Regulation) section 25136-2(c)(2) states that, in determining the sales factor, the location where the benefit is received can be determined from cascading rules examining, for example, contracts, books and records, customer billing address, or from a reasonable approximation. The regulation states that, to the extent the location of the

[2] As stated in the original Opinion, Regulation section 25136-2 is applicable to appellant pursuant to Regulation section 25136-2(f), which states that, if a nonresident is a shareholder of an S corporation which carries on a unitary business, trade or profession within and without this state, the amount of the nonresident's pro rata share of S corporation income derived from sources within this state shall be determined in the same manner as if the S corporation were a partnership, which, as described under Regulation section 17951-4(d)(1), includes applying the Uniform Division of Income for Tax Purposes Act (the UDITPA), as codified in R&TC sections 25120-25139.

benefit of the services is indicated by the first cascading rule, a rebuttable presumption is created that may be overcome based on a preponderance of evidence, which is broadly defined and also does not include a specific tax return requirement. (Cal. Code Regs., tit. 18, § 25136-2(c)(2)(A).) Therefore, FTB's own regulations provide evidentiary requirements contrary to the requirements proposed by FTB in its PFR without any supporting legal authorities.[3]

We note that the Opinion determined that appellant has a filing requirement and also acknowledged that taxpayers must file a return to receive certain benefits, such as with regard to itemized deductions.[4] We also note it has been held that taxpayers are not in a good position to criticize FTB's estimate of their liability when they fail to file a required return and, in addition, subsequently refuse to submit information upon request. (*Appeals of Dauberger et al.*, *supra*.) However, there is no legal authority to support FTB's contention that OTA was precluded here from making its determination because a return had not been filed. Here, appellant was unclear as to whether he had a filing requirement and was cooperative and provided supporting documentation. Appellant submitted documentation establishing that FTB's determination of appellant's California taxable income included income sourced outside of California and that the determination should be revised. In addition, FTB does not argue that OTA's reduction to California source income was contrary to the apportionment rules of the Uniform Division of Income for Tax Purposes Act (the UDITPA), as codified in R&TC sections 25120-25139. Accordingly, OTA properly determined that appellant's California source income (and thus the resulting tax liability) should be revised.

[3] We note that, while FTB asserts that a return must be filed before OTA can apportion income, income must be apportioned so it can be determined whether the income in question is California source income and whether appellant has a California filing requirement. Thus, OTA could not require appellant, who argues he has no filing requirement, to file a return as a preliminary matter before apportioning income, as the determination of whether he has a filing requirement can only come after apportioning income to determine the amount (if any) of appellant's California source income.

[4] See R&TC section 17073(a), applying Internal Revenue Code section 63(e)(1)-(2) [no itemized deduction shall be allowed unless the election is made on the taxpayer's return].

FTB notes that the Opinion quoted the TBOR in its discussion concluding that appellant was not required to file a tax return in order to reduce his tax liability.[5] FTB argues that there was an irregularity in the proceedings because it was not given the opportunity to address this issue, but had it been allowed to do so, it would have raised the "truly problematic nature of allowing a taxpayer to apportion income when no return has been filed and that, without a return, there is insufficient information to accurately apportion income."[6]

In this case, the matter was discussed by FTB in more than one brief. For instance, FTB stated that "[a]ppellant may not use the appeals process to avoid filing a tax return for which he is legally obligated. Instead, if appellant disagrees with [FTB's] assessment or any portion thereof, he must file a tax return." Furthermore, FTB acknowledged that appellant had non-California source income during the briefing process, but asserted that appellant had not filed a return, so no adjustments could be made. FTB stated that some invoices indicated services outside of California, but because at least three of the invoices indicated service charges related to California totaling at least $25,945.86, then the entire distributive share income totaling $411,133 should be presumed to be California source income. Specifically, FTB asserted during briefing that, while certain documentation indicated that "the benefit of his services was received in London," "at least three of the invoices previously provided by appellant refer to Citrix Anaheim [California]." FTB then stated that "the benefit of the services referred to in those invoices was received in California…" and "[t]herefore, the distributive share received by appellant is considered California source income…."

Thus, FTB acknowledged that appellant had both California and non-California source income, but also asserted that the entire distributive share was California source income, and that appellant must file a return to show otherwise. Accordingly, whether appellant was required to file a tax return to reduce his tax liability was already discussed during the original briefing process, as it was an issue raised by FTB, and the matter was addressed by OTA. As stated in

[5] The relevant quote from the Opinion is as follows: "The Legislature further finds and declares that the purpose of any tax proceeding between the Franchise Tax Board and a taxpayer is the determination of the taxpayer's correct tax liability. It is the intent of the Legislature that, in the furtherance of this purpose, the Franchise Tax Board may inquire into, and shall allow the taxpayer every opportunity to present, all relevant information pertaining to the taxpayer's liability." (R&TC, § 21002.) The quote was provided to support the statement in the Opinion that we may not disregard evidence and argument that would reduce the proposed deficiency only because appellant has not filed a tax return.

[6] We note that, except for reimbursement claims under R&TC section 21013, we have no jurisdiction to decide matters based on alleged violations of the TBOR. (*Appeal of Jacqueline Mairghread Patterson Trust*, 2021-OTA-187P.)

the Opinion, just because the evidence showed that a portion of FTB's original determination was correct, does not mean that the entirety of FTB's determination should be upheld unless and until appellant files a California return. In conclusion, FTB has not established that the Opinion was contrary to law or that there was an irregularity in the proceedings.

Demand Penalty

FTB argues that the Opinion is contrary to law because the interpretation and application of Regulation section 19133 was contrary to law. FTB issued a 2013 Demand for Tax Return to appellant on May 5, 2015, but appellant did not provide a response. Therefore, the Opinion examined whether the prerequisites of Regulation section 19133(b) were satisfied. For the 2012 tax year, FTB issued a Demand for Tax Return on June 17, 2014, and a Notice of Proposed Assessment (NPA) on August 25, 2014. For the 2011 tax year, FTB issued a Request for Tax Return on March 13, 2013, and an NPA on May 13, 2013. The Opinion determined that, because the 2011 and 2012 NPAs were not issued "during" the four tax years prior to 2013 (i.e., during 2012, 2011, 2010, or 2009), the prerequisites of Regulation section 19133(b) were not satisfied, and the demand penalty was to be abated.

The underlying Opinion in this appeal was issued on February 1, 2021. However, on March 4, 2021, OTA issued the precedential Opinion *Appeal of Jones*, 2021-OTA-144P (*Jones*). As with the underlying Opinion in this appeal, *Jones* involved the application of Regulation section 19133(b). While both opinions addressed the same regulation and language therein, as the regulation has not been altered, *Jones* provided an interpretation of the regulation that differed from the interpretation applied in the underlying Opinion of this appeal. Specifically, *Jones* held that Regulation section 19133(b) should be interpreted to be consistent with Example 2 of the regulation, which allows for imposition of the penalty when the NPAs were issued "for" (not "during") one of the four tax years prior to the current tax year. Prior to *Jones*, there was no precedential OTA opinion (or court opinion) on the issue of interpreting Regulation section 19133.

In the present appeal involving the 2013 tax year, the appeal record includes NPAs issued to appellant for the 2011 and 2012 tax years after FTB issued a Request for Tax Return and Demand for Tax Return, respectively. As previously noted, *Jones* held that the penalty is properly imposed under the regulation when an NPA is issued "for" one of the four tax years prior to the current tax year. Therefore, the interpretation of the regulation in *Jones* is material to

the issue of the demand penalty in the current appeal, as the NPAs in the appeal record indicate that the prerequisites of the regulation would be satisfied under *Jones*.

Given these circumstances, we find that there is sufficient basis to find that the underlying Opinion in this appeal, which is not yet final, is contrary to law as to the issue of the application of Regulation section 19133(b), such that a rehearing should be granted.[7] Accordingly, we grant a rehearing on the demand penalty issue only for the purposes of determining whether the demand penalty was properly imposed, including whether the prerequisites of the regulation are satisfied under the precedential Opinion in *Jones* and, if it is determined that the penalty was properly imposed, whether appellant has shown reasonable cause for failing to timely respond to the Demand for Tax Return for the 2013 tax year, such that the penalty may be abated.

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Josh Lambert
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Josh Lambert
Administrative Law Judge

We concur:

DocuSigned by:
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Cheryl L. Akin
Administrative Law Judge

DocuSigned by:
Andrea LH Long
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Andrea L. H. Long
Administrative Law Judge

Date Issued: 8/11/2021

This Opinion was revised pursuant to Regulation section 30506 on 3/8/2022

[7] For example, see the discussion of judicial decisions interpreting the language of a statute and their retroactive effect on nonfinal cases in *Vazquez v. Jan-Pro Franchising International, Inc*. (2021) 10 Cal.5th 944, 952, citing *Rivers v. Roadway Express, Inc*. (1994) 511 U.S. 298, 312-313 ["A judicial construction of a statute is an authoritative statement of what the statute meant before as well as after the decision of the case giving rise to that construction."].)