OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **J. ZHAO AND** **Y. LIU**	) OTA Case No. 21057711)))))

OPINION ON PETITION FOR REHEARING

Representing the Parties:

For Appellants: Cindy L. Ho, Attorney

For Respondent: Desiree Macedo, Tax Counsel

A. LONG, Administrative Law Judge: On December 1, 2021, the Office of Tax Appeals (OTA) issued an Opinion sustaining the Franchise Tax Board's (respondent's) proposed assessment of additional tax.

Appellants filed a timely petition for rehearing under California Code of Regulations, title 18, (Regulation) section 30604. Appellants do not explicitly state upon which grounds they file the instant petition for rehearing. However, it appears to OTA that appellants are arguing that the Opinion is "contrary to law," pursuant to Regulation section 30604(a)(5).

OTA may grant a rehearing when one of the following grounds is met and materially affects the substantial rights of the party seeking a rehearing: (1) an irregularity in the proceedings that occurred prior to the issuance of the Opinion and prevented fair consideration of the appeal; (2) an accident or surprise that occurred during the appeals proceeding, 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 written Opinion; (4) insufficient evidence to justify the written 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); *Appeal of Do*, 2018-OTA-002P.) Regulation section 30604 is based upon the provisions of the Code of Civil Procedure (CCP) section 657, case law pertaining to the

operation of CCP section 657, as well as the language of the statute itself, and are persuasive authority in interpreting the provisions contained in this regulation.

To find that an opinion is against or contrary to law, we need not reweigh the evidence but must find that the opinion is "unsupported by any substantial evidence." (*Appeal of Graham and Smith*, 2018-OTA-154P, citing *Sanchez-Corea v. Bank of America* (1985) 38 Cal.3d 892, 906.) This requires a review of the opinion to indulge in all legitimate and reasonable inferences to uphold the opinion. (*Appeals of Swat-Fame, Inc., et al.*, 2020-OTA-045P.) The relevant question is not over the quality or nature of the reasoning behind the opinion but whether the opinion can be valid according to the law. (*Ibid*.) We consider the evidence in the light most favorable to the prevailing party (here, respondent). (*Ibid*.)

In the Opinion, OTA determined that appellants improperly deducted $107,316 as a charitable contribution made to the Lotus Creek Foundation (Foundation) during the 2012 tax year because the contribution did not meet the statutory definition of a charitable contribution under Internal Revenue Code (IRC) section 170(c)(2).[1] Appellants established the Foundation, which became a private tax-exempt foundation effective December 22, 2010. The Foundation, however, lost its tax-exempt status effective May 29, 2012, after respondent examined the Foundation's exemption status. Respondent determined that the Foundation purchased and paid for the expenses of a BMW, which was exclusively used by appellant-Zhao; paid the personal expenses of appellant-Zhao to renew his driver license; purchased investment property and paid for the expenses incurred for renovating and landscaping the property; among others. Respondent concluded that "[a]lthough investment activity can be acceptable as long as there is also substantial charitable activity, … the Foundation has only minimally engaged in charitable activities." OTA held that these actions also were proof of private inurement, in violation of IRC section 170(c)(2)(C).

[1] Revenue and Taxation Code section 17201(a) incorporates by reference IRC section 170.

Although OTA reviewed the bases for the Foundation's revocation of tax-exempt status, it did not question whether respondent's revocation against the Foundation was proper. The Opinion states:

> Although we do not have jurisdiction in this appeal to review whether respondent's revocation of the Foundation's tax-exempt status was proper, as the Foundation is not an appealing taxpayer in this appeal, the bases for respondent's revocation are nevertheless relevant to this appeal because both [Revenue and Taxation Code (R&TC)] section 23701d and IRC section 170(c)(2) require that no net earnings inure to the benefit of private shareholders or individuals.

The Opinion considered the bases for the revocation because it was relevant in OTA's analysis of whether appellants' contribution was deductible under IRC section 170. The Opinion determined that appellants' contribution failed to meet the statutory definition of a charitable contribution because there was evidence of private inurement, which is prohibited under IRC section 170(c)(2)(C). Specifically, the Foundation purchased a luxury vehicle for private purposes, used its assets to pay for appellants' personal expenses, and transferred its assets directly to appellants' bank account. Appellants did not provide any evidence to contradict respondent's findings. As such, we find that there was substantial evidence to uphold the Opinion, and the Opinion is valid according to law.

Appellants argue that Revenue Procedure 2018-32, 2018-23 I.R.B. 739, allows a deduction for any contribution made after an organization ceases to qualify under IRC section 170 and prior to the public announcement or posting of the revocation unless the grantor was in part responsible for, or aware of, the activities or deficiencies that gave rise to the revocation. Appellants contend that they were misled by the advice of the Foundation's CPA, which resulted in appellants engaging in activities that would later be the basis for the revocation of the Foundation's tax-exempt status. Appellants therefore contend that based on their reliance on the CPA, appellants are not responsible for the activities that gave rise to the loss of the Foundation's tax-exempt status.

Section 4.01 of Revenue Procedure 2018-32 provides the following:

> If an organization listed in or covered by Tax Exempt Organization Search (Pub. 78 data) or the EO BMF Extract ceases to qualify as an organization to which contributions are deductible under [IRC section] 170 and the IRS revokes a determination letter or ruling concluding that the organization is one to which contributions are deductible under [IRC section] 170, grantors and contributors to that organization may generally rely on the determination letter or ruling

> information provided in Tax Exempt Organization Search (Pub. 78 data) or the EO BMF Extract that contributions to the organization are deductible under [IRC section] 170 until the date of a public announcement stating that the organization ceases to qualify as an organization contributions to which are deductible under [IRC section] 170.

Revenue Procedure 2018-32, section 4.04 states that the IRS may nevertheless disallow a deduction for a charitable contribution made after the organization ceases to qualify under IRC section 170(c) and prior to the public announcement or posting of the revocation if the grantor or contributor: (1) had knowledge of the revocation of the determination or ruling prior to public announcement or posting; (2) was aware that such revocation was imminent; or (3) was in part responsible for, or was aware of, the activities or deficiencies on the part of the organization that gave rise to the loss of qualification.

Here, appellants' reliance on Revenue Procedure 2018-32 is misplaced. This Revenue Procedure provides guidance for grantors and contributors who made a charitable contribution to an organization that was once listed on the Tax Exempt Organization Search or the EO BMF Extract.[2] However, organizations that wish to be tax exempt in California must separately apply for an exemption with the Franchise Tax Board. (R&TC, § 23701.) As such, reliance on these federal databases would be insufficient to prove that a taxpayer's contribution is deductible as charitable contribution for California purposes because an organization that is exempt from federal income tax does not automatically exempt it from California taxes.[3] As such, the Revenue Procedure guidance is inapplicable here.[4]

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[2] To assist the general public, the IRS maintains and updates two different publicly available compilations of information on organizations eligible to receive tax-deductible contributions under IRC section 170. The first compilation lists organizations that are eligible to receive tax-deductible charitable contributions (eligible organization list) and the second compilation is an extract of certain information concerning tax-exempt organizations from the IRS electronic Business Master File (BMF) (the EO BMF Extract). (Rev. Proc. 2018-32, *supra*, § 3.)

[3] It is also noted that appellants have not contended or provided any evidence that the Foundation was listed on the IRS Tax Exempt Organization Search or the EO BMF Extract.

[4] Even if the Revenue Procedure were applicable, appellants' participation in the Foundation, and the transactions that the Opinion found inured to their benefit, would still result in the disallowance of the deduction under Revenue Procedure 2018-32 section 4.04.

Based on the foregoing, appellants have not shown grounds exist for a new hearing as required by the authorities referenced above, and appellants' petition for rehearing is hereby denied.

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Andrea L.H. Long
Administrative Law Judge

We concur:

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Cheryl L. Akin
Administrative Law Judge

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Asaf Kletter
Administrative Law Judge

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