OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **M. MACLEOD (DEC'D) AND K. MACLEOD**[1]	OTA Case No. 18093762

OPINION

Representing the Parties:

For Appellant: Michael C. Hamersley, Attorney

For Respondent: Ciro Immordino, Assistant Chief Counsel
Marguerite Mosnier, Attorney V

For Office of Tax Appeals: Mai Tran, Tax Counsel IV

S. HOSEY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, M. MacLeod (Dec'd) and K. MacLeod (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing additional assessments for the 2006 and 2007 tax years.[2]

Office of Tax Appeals Administrative Law Judges Sara A. Hosey, Huy "Mike" Le, and Amanda Vassigh, held an oral hearing for this matter in Sacramento, California, on September 21, 2022. At the conclusion of the hearing, the record was closed and this matter was submitted for decision.

[1] M. and K. MacLeod filed joint returns for the years at issue and filed an appeal of the Franchise Tax Board's (FTB's) proposed assessments. M. MacLeod passed away on April 23, 2018, during the protest process at FTB. The transactions at issue involve real property owned by M. MacLeod through certain pass-through entities. For ease of reference, appellant will refer to M. MacLeod.

[2] For the 2006 tax year, FTB proposed additional tax of $63,054, plus applicable interest, and a late filing penalty of $15,352. For the 2007 tax year, FTB proposed additional tax of $9,101, plus applicable interest.

ISSUES

1. Whether appellant has shown that he sold real property in an Internal Revenue Code (IRC) section 170 “bargain sale” of the Palm Springs Whole Parcel (Palm Springs Land).
2. Whether appellant must recognize gain under IRC section 731.
3. Whether FTB’s exchange of information with the IRS bars it from pursuing its proposed California tax deficiencies or forces it to accept the results of federal audit and subsequent court-approved settlement based on res judicata principles.
4. Whether appellant has shown interest should be abated pursuant to R&TC section 19104.
5. Whether appellant has shown reasonable cause to abate the late filing penalty for the 2006 tax year.

FACTUAL FINDINGS

Sale of the Palm Springs Land

1. Appellant owned a 70.73-acre parcel of land in Palm Springs (Palm Springs Whole Parcel) through MacLeod-Couch Land Company LLC (MC Land Company) and MacLeod Couch Properties LLC (MC Properties LLC). Appellant held a total of 58.1207 percent in direct and indirect interests in MC Properties LLC: direct interest in MC Properties LLC (34.72 percent), indirect interest through MacLeod Family Limited Partnership (13.3987 percent), and indirect interest through MacLeod Wolff LLC (10.0020 percent).[3]
2. MC Land Company and MC Properties LLC purchased the Palm Springs Land in or around 1980.
3. In 2003, the Palm Springs Unified School District (School District) sought to purchase approximately 25.00 acres of raw land. These 25.00 acres included 19.16 acres of appellant’s Palm Springs Land and 5.38 acres owned by an unrelated third party, Rilington Dolce, LLC (RD LLC).
4. In late 2003 or during 2004, the School District and appellant engaged in discussions for

[3] MC Properties LLC has four members: appellant (34.73 percent), S. Wolff (15.28 percent), MacLeod Wolff LLC (16.67 percent), and MacLeod Family Limited Partnership (33.32 percent). MacLeod Wolff LLC has two members: appellant (60 percent) and S. Wolff (40 percent). MacLeod Family Limited Partnership has 4 partners: appellant (39 percent), S. Wolff (39 percent), A. MacLeod (20 percent), and MacLeod Wolff LLC (2 percent).

the School District to buy appellant's Palm Springs Land. At the same time, the School District also engaged in discussions with RD LLC to buy RD LLC's 5.38 acres of land.

5. On September 7, 2004, appellant's attorney sent a letter to the School District, informing the School District that appellant would seek an independent third-party appraisal for the Palm Springs Land.
6. On November 30, 2004, Anderson & Brabant, Inc. prepared an appraisal of the Palm Springs Land on behalf of appellant indicating a valuation of $400,000 per acre as of the date of the appraisal.
7. On December 27, 2004, Parkcenter Realty Advisors prepared an appraisal of a combined parcel of the Palm Springs Land and RD LLC's land on behalf of the School District. The appraisal had a valuation date of December 20, 2004, and an appraised value of $7.6 million (approximately $304,000 per acre).
8. On March 28, 2005, R. Dozier prepared an appraisal of the Palm Springs Land on behalf of appellant (Dozier Appraisal). The Dozier Appraisal valued the Palm Springs Land at $539,568 per acre with a severance damage of $433,323.
9. On April 18, 2005, Anderson & Brabant, Inc. prepared an updated appraisal on behalf of appellant (Updated Anderson & Brabant Appraisal). The updated appraisal valued the Palm Springs Land at $550,000 per acre with a severance damage of $172,500.
10. In a letter dated July 18, 2005, to the School District's representative, appellant's attorney responded to a voicemail from the School District's attorney. The letter informed the School District of the Dozier Appraisal and the Updated Anderson & Brabant Appraisal. The letter indicated that appellant received offers of up to $650,000 per acre from other prospective buyers, but that it was unclear whether any of those buyers would complete the transaction. The letter also stated that appellant would prefer selling the property to the School District in lieu of a condemnation because of potential tax benefits. The letter proposed that the School District buy the land at $550,000 per acre with no severance damage to the remainder parcel and that the School District and appellant would agree to an additional amount of value considered as a "gift" to the School District.
11. In a letter dated July 29, 2005, the School District's attorney responded clarifying that his voicemail confirmed that the School District did not have a final offer from appellant and that appellant was free to dispose of and/or develop his property as he wishes. The letter

further stated that the School District anticipated receiving another appraisal in August 2005. The School District acknowledged that the prior appraised value was too low.

12. On August 8, 2005, the School District received an updated appraisal from Parkcenter Realty Advisors. The updated appraisal report valued the Palm Springs Land as of July 14, 2005, at $10,411,000 with $485,000 in severance damages, for a total of $555,635 per acre.

13. On October 4, 2005, Parkcenter Realty Advisors provided an updated appraisal indicating that the actual acreage of the Palm Springs Land was 19.16, not 19.61 or 19.81 as previously used in the August 8, 2005 appraisal. The October 4, 2005 updated appraisal valued the Palm Springs Land, including severance damages, at $10,538,000 (i.e., $550,000 per acre).

14. On November 10, 2005, the School District sent appellant a letter which discussed the October 4, 2005 appraisal, offering to purchase the land for $10,538,000. On the same day, the School District also sent appellant a notice that the School District was beginning the steps necessary for eminent domain proceedings.

15. On November 29, 2005, the School District and appellant's entities, MC Land Company and MC Properties LLC, entered into an agreement for the sale of the Palm Springs Land (Purchase Agreement). The sale price for the Palm Springs Land was $10,538,000 (i.e., 19.16 acres x $550,000).

16. Paragraph D of the Purchase Agreement states:

> Seller has been informed by a duly authorized representative of the District that the District, which is a government agency with the power of eminent domain in the jurisdiction where the Property is located, is prepared to institute eminent domain proceedings to acquire the Property, and Seller has a reasonable belief that necessary steps to condemn the Property will be instituted if a voluntary sale is not arranged between the District and the Seller.

17. The second paragraph of Section 1.2 of the Purchase Agreement states:

> Seller contends that the value of the Property well exceeds the Purchase Price. Seller may take the position that its claimed excess value is a gift and deems it to be treated as such by Seller. Buyer does not endorse Seller's position and contention.

18. On November 22, 2005, the School District also entered into a purchase agreement with RD LLC to purchase RD LLC's portion of the land for $550,000 per acre. Section 1.2 of this agreement does not contain the language regarding whether a portion of the land sold by RD LLC was a gift.
19. On April 28, 2006, the escrows closed for both sales and the deeds were recorded. As part of the sale, a portion of the proceeds was used to satisfy the mortgage on the Palm Springs Land. As a result, appellant was relieved of $160,490 of the partnership liability.

<u>Appellant's Tax Return Position and FTB Audit</u>

20. According to appellant, his tax preparer, who was in possession of appellant's records for the 2006 tax year, suffered an illness and passed away in October 2007.
21. On November 29, 2007, appellant filed an untimely 2006 tax return.
22. Appellant filed a timely 2007 tax return.
23. Appellant initially did not report the sale of the Palm Springs Land as a bargain sale and charitable contribution on his 2006 federal and state tax returns. Instead, appellant reported an IRC section 1033 deferral based on the threat of eminent domain.[4]
24. On September 17, 2009, FTB notified appellant that it was examining appellant's tax returns for the years at issue, with regards to the claimed IRC section 1033 deferral and appellant's partner basis information.
25. On or about October 10, 2010, appellant filed an amended 2006 California tax return, claiming, among other items, a bargain sale of the Palm Springs Land generated by MC Properties LLC and passed through to appellant. Appellant took the bargain sale position in addition to the IRC section 1033 deferral position.[5]
26. Each amended Schedule K-1 from the pass-through entities reported a non-cash charitable contribution, for a total of $5,566,215.[6] Since the non-cash contribution was

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[4] Appellant's original returns are not in the record. OTA only has partial copies of his amended 2006 federal and state tax returns.

[5] A sale qualifies for IRC section 1033 deferral if the sale takes place as a result of "requisition or condemnation or threat or imminence thereof." (IRC, § 1033(a).) "An involuntary conversion may be the result of the destruction of property in whole or in part, the theft of property, the seizure of property, the requisition or condemnation of property, or the threat or imminence of requisition or condemnation of property." (Treas. Reg. § 1.1033(a)-1(a).)

[6] This amount is calculated as: $3,325,134 (MC Properties LLC) + $1,244,885 (MacLeod Family Limited Partnership) + $996,196 (MacLeod Wolff LLC).

limited to 30 percent of adjusted gross income, appellant reported a charitable contribution deduction of $56,948. Appellant stated that the excess charitable deduction would be carried forward to subsequent tax years.

27. On Form 8283, Noncash Charitable Contributions, attached to the amended 2006 tax return, appellant reported the sale of the Palm Springs Land as having an appraised fair market value of $20,115,000. Appellant reported that his basis was $541,296, the bargain sale amount received was $10,538,000, and the amount claimed as a deduction was $9,577,000. Appellant also attached a statement indicating that the School District would not sign the Form 8283, as required in Section B. Appellant asserted that the School District did not sign the form because the School District was concerned about liability since the Palm Springs Land was purchased under a threat of condemnation.

28. To support the claimed appraised fair market value of $20,115,000, appellant provided an appraisal prepared by M. Scarella and dated September 15, 2010 (2010 Appraisal), which valued the land at about $1,049,843 per acre.

29. According to a letter dated April 27, 2011, from the School District to FTB, the School District did not agree with appellant's contention that part of the transfer of the Palm Springs Land was a charitable contribution. The School District stated that "[t]he District took specific action to make sure that the Purchase Agreement was clear of the District's intention regarding the claim of excess value as a charitable gift."

30. On May 26, 2011, FTB issued an Audit Issue Presentation Sheet to MC Properties LLC, revising the claimed IRC section 1033 deferred gain to $9,996,704 and disallowing the charitable contribution deduction of $9,577,000.

31. On or about June 2, 2011, FTB calculated appellant's tax basis in MC Properties LLC and determined appellant had taxable gain of $657,930 under IRC section 731.[7]

32. On October 3, 2011, FTB issued its audit closing letter, which determined that appellant was not entitled to a charitable contribution for excess value since there was no bargain sale of the Palm Springs Land.

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[7] According to FTB, appellant's tax basis at the beginning of the year was $32,428 (i.e., $144,127 capital account at the beginning of the year) + $176,555 in appellant's share of partnership liabilities (i.e., $508,510 x 34.72 percent). Appellant's tax basis at the end of the year was -$59,180 (i.e., $32,428 + $8,460 allocation of interest income + $ 60,422 allocation of tax-exempt interest income - $160,490 reduction in partnership liabilities). Appellant had actual withdrawals and distributions of $598,750. Appellant's total IRC 731 gain was calculated as $657,930 (i.e., $59,180 + $598,750).

33. On October 14, 2011, FTB issued a Notice of Proposed Adjusted Carryover Amount (NPACA) to MC Properties LLC. FTB disallowed the charitable contribution deduction of $9,577,000. That same day, FTB issued NPACAs to the MacLeod Family Limited Partnership and MacLeod Wolff LLC, disallowing the flow-through charitable contribution deduction from MC Properties LLC.
34. On October 25, 2011, FTB issued a Notice of Proposed Assessment (NPA) to appellant for the 2006 tax year, disallowing the flow-through charitable contribution deduction resulting from the sale of the Palm Springs Land. In addition, FTB determined that appellant took cash distributions in excess of his basis in the pass-through entities and that the resulting capital gain is taxable. FTB proposed to increase appellant's taxable income by $686,888 of IRC section 731 gain and $91,461 in disallowed itemized deductions. The increase in taxable income resulted in a proposed assessment of $63,054 in additional tax. The NPA also proposed a $15,352 late filing penalty, plus applicable interest.
35. On October 25, 2011, FTB also issued an NPA to appellant for the 2007 tax year, disallowing the charitable contribution deduction carried over from the 2006 tax year. FTB proposed to increase appellant's taxable income by $130,110 in disallowed itemized deductions and proposed $9,101 in additional tax, plus applicable interest.[8]
36. Appellant protested the NPAs.
37. On January 8, 2013, appellant informed FTB that the IRS was examining the 2006 sale of the Palm Springs Land. Appellant requested FTB to defer its audit until the conclusion of the federal audit.
38. On February 21, 2013, FTB agreed to the deferral until appellant resolved the federal audit.

<u>IRS Audit and Outcome</u>

39. Appellant did not report gain from the sale on the 2006 federal tax return. Appellant took the position that the gain was deferred under IRC section 1033 for involuntary conversions.
40. Appellant filed amended federal tax returns for the 2006, 2007, 2008, and 2009 tax years

[8] FTB applied the interest suspension per R&TC section 19116.

claiming a charitable contribution from the purported bargain sale. Although the 2006 amended return was not processed, the IRS processed and issued refunds for the 2007, 2008, and 2009 amended tax returns which claimed charitable contribution carryovers from 2006. The total amount deducted on the processed amended returns for the 2007 through 2009 tax years was $753,008.

41. By letter dated February 15, 2013, FTB shared information with the IRS, including a copy of the Purchase Agreement, the April 27, 2011 letter from the School District, the July 18, 2005 letter from appellant's attorney, the November 10, 2005 letter from the School District, the July 21, 2005 appraisal from Robert Steele of Parkcenter Realty Advisors, Form 8283 and attachments, and the 2010 Appraisal. FTB also indicated that a February 15, 2007 appraisal done on behalf of a third party by M. Scarella listed the sale of the Palm Springs Land as a comparable sale for a similar parcel of land.[9] The February 15, 2013 letter also discussed FTB's position on the IRC section 731 issue.

42. By letter dated March 6, 2013, appellant informed FTB that the IRS was considering the bargain sale issue as well as the IRC section 731 issue.

43. According to FTB, on May 29, 2013, the IRS auditor informed FTB that the IRS reviewed the charitable contribution issue, but not the IRC section 731 issue. On October 7, 2015, the IRS Appeals Office informed FTB that the IRC section 731 issue had not been reviewed.

44. By letter dated January 13, 2014, the IRS stated that it had determined that the sale of the Palm Springs Land was neither a charitable contribution nor a bargain sale, and that the sale price in the Purchase Agreement represented fair market value. The IRS reviewed the 2006, 2010, and 2011 tax years. The letter did not discuss the IRC section 731 issue.

45. The IRS auditor determined that the transfer of the Palm Springs Land was not a charitable contribution nor a bargain sale because the sales price of $10,538,000 represented fair market value. The IRS auditor's determination was based on an onsite inspection of the Palm Springs Land, an IRS appraisal, and third-party witness statements. In discussion with the IRS auditor, both the attorney and the then-Director of

[9] This appraisal is not in the record. According to the IRS Appeals Case Memo, the 2007 appraisal indicated that the Palm Springs Land was not under threat of eminent domain and the sales price was negotiated at arms-length. Although M. Scarella knew of the comparable sales listed in the 2007 appraisal, he omitted them in the 2010 Appraisal. During the appeal of the federal audit, appellant made various arguments as to why the 2010 Appraisal was appropriate.

the School District stated that the taxpayer's statements on the Form 8283 were inaccurate and misrepresented the School District's position at the time of the sale. The IRS also mentioned that it contacted FTB to obtain FTB's findings of the bargain sale issue.

46. Appellant appealed the IRS audit determination. According to the IRS Appeals Office Case Memo, which appears to be prepared for settlement purposes, the IRS determined that appellant would face significant litigating hazards due to: contemporaneous appraisals reflecting values close to the purchase price, appellant's 2010 Appraisal prepared after the transfer date which differed dramatically from a contemporaneous appraisal prepared by the same appraiser for a similar property, and unfavorable third party testimony from the School District.

47. The IRS also determined that the government had some litigating hazards due to the possibility that the Tax Court might accept the 2010 Appraisal, slight litigation hazard for appellant's explanation that he accepted a lower price to avoid eminent domain proceedings, and no litigation hazard for FTB's determination.[10]

48. The IRS determined that its litigating hazards were much less than appellant's hazards and concluded that the IRS had a 2 in 3 chance of prevailing. The IRS quantified its risk as 33 percent. The IRS determined that a reasonable settlement would be to allow a total charitable deduction equal to $3,202,430 (i.e., 33 percent of the difference between appellant's 2010 Appraisal of $20,115,000 and the sales price of $10,538,000). The IRS accepted appellant's settlement proposal for an allowance of the deduction claimed on the 2010 tax return of $114,792, and a disallowance of $800,000 of the $3,134,630 deduction claimed on the 2011 tax return, which equaled a total allowed deduction of $3,202,430 (i.e., $753,008 + $114,792 + $2,334,630).[11]

[10] Appellant suggested that FTB's determination was a litigation hazard for the IRS.

[11] There was no change for appellant's 2006 tax return since the 2006 amended federal return was unprocessed and the 2006 federal tax year was untimely appealed. Appellant deducted a total of $738,008 in 2007, 2008, and 2009 (these years were not audited). Appellant was allowed a deduction of $114,792 for 2010 and $2,334,630 for 2011.

49. On April 30, 2015, the United States Tax Court issued a stipulated decision approving the settlement.[12] The decision stated that, pursuant to the agreement of the parties, there was a deficiency for the 2011 tax year, but there was no deficiency nor overpayment for the 2006 and 2010 tax years. The parties also agreed that there were no penalties under IRC section 6662(a) for the 2010 and 2011 tax years.

FTB's Actions Post-Federal Determination

50. By letter dated July 16, 2015, appellant informed FTB that there was no federal income tax deficiency or federal income tax due for the 2006 or 2007 tax years. Appellant requested that FTB withdraw its assessment.
51. On July 26, 2015, FTB requested appellant's federal information from the IRS.
52. On August 28, 2015, FTB again requested information from the IRS.
53. On December 18, 2015, FTB requested appellant to provide additional information regarding the federal determination. FTB noted that, although FTB makes an independent determination, in making that determination, FTB would consider the analysis by the IRS on a similar issue.
54. On March 24, 2016, the IRS provided the Form 4549-A, Income Tax Discrepancy Adjustments, and attachments for the 2006 tax year. The IRS auditor indicated that it had disallowed the 2006 claim for refund and that the associated charitable contribution carry forward was disallowed in full.
55. On March 28, 2016, FTB sent appellant an update stating that it had not yet received federal information requested from the IRS.
56. On July 4, 2016, FTB followed up with the IRS regarding the IRS workpapers.
57. On September 27, 2016, FTB received the IRS Appeals Office Case Memo discussed above.
58. On April 24, 2017, the IRS informed FTB that the IRS was having trouble finding the items requested by FTB.
59. From May 12, 2017, to May 22, 2018, FTB reviewed and analyzed the case and prepared for the protest hearing.

[12] According to the United States Tax Court's website, if the taxpayer settles with the IRS, the IRS prepares a settlement document (i.e., stipulated decision) which both parties sign and the Tax Court enters the decision into the official record. (See https://www.ustaxcourt.gov/taxpayer_info_before.htm.)

60. On May 30, 2018, FTB held a protest hearing with appellant.
61. On July 3, 2018, FTB issued its protest determination letter.
62. On August 1, 2018, FTB issued Notices of Action to appellant affirming the assessments for the years at issue.
63. Appellant then filed this timely appeal.

DISCUSSION

Issue 1: Whether appellant has shown that he sold real property in an IRC section 170 "bargain sale" of the Palm Springs Land.

a. Applicable Law

Deductions are a matter of legislative grace, and the taxpayer has the burden of showing entitlement to any deduction claimed. (*Appeal of Dandridge*, 2019-OTA-458P.)

IRC section 170 allows a taxpayer a deduction for any charitable contribution to a qualified charitable organization.[13] A taxpayer who makes a bargain sale to a charity is generally entitled to a charitable contribution deduction equal to the difference between the fair market value of the property and the amount realized from the sale. (*Knott v. Commissioner* (1977) 67 T.C. 681; *Waranch v. Commissioner*, T.C. Memo. 1989-596.) The fair market value of a property is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." (Treas. Reg., § 1.170A-1(c)(2).) To qualify as a bargain sale, the taxpayer must show that: (1) the fair market value of the property on the date of the sale exceeds the selling price; and (2) the taxpayer must have made the sale with the intention of making a gift. (*Consolidated Investors Group v. Commissioner*, T.C. Memo. 2009-290; *Fakiris v. Commissioner*, T.C. Memo. 2017-126.)

A taxpayer who negotiates for the best terms he or she can obtain in a sales transaction cannot subsequently claim a deduction based upon any excess value of the contributed property over the consideration received. (*Waranch v. Commissioner*, *supra*, citing *Southern Pacific Transportation Co. v. Commissioner* (1980) 75 T.C. 497, 604 and *Grinslade v. Commissioner* (1973) 59 T.C. 566, 577.) In *Hope v. United States* (1991) 23 Cl. Ct. 776, the court held that a

[13] IRC section 170 is incorporated into California by R&TC section 17201(a). IRC section 170(c) defines the term "charitable contribution" as "a contribution or gift" to or for the use of certain specified organizations.

taxpayer whose property was the subject of condemnation proceedings and who was paid compensation as a result of negotiated settlement agreement could not later characterize the condemnation transaction as a "bargain sale" and claim charitable contribution for the difference between what the taxpayer asserted was fair market value and what was received in settlement.[14] The fact that the landowner, after appealing the initial valuation decision of the state, in arms-length settlement negotiation, voluntarily settled for an amount less than what he subsequently alleged to be fair market value, did not establish that he failed to receive just or adequate consideration. (*Id*. at 787.)

b. Analysis

Here, the evidence shows that appellant received fair market value consideration for the Palm Springs Land when the property was sold to the School District. Appellant and the School District engaged in lengthy negotiations for the sale of the land. Although the School District notified appellant that it would seek condemnation proceedings, appellant and the School District ultimately agreed to a sale of the land. There were multiple appraisals prepared at the time of the sale reflecting the value to be approximately $550,000 an acre, which was what the School District paid to appellant. The School District also paid $550,000 an acre to RD LLC for its land as well. In addition, according to the April 27, 2011 letter from the School District, the School District stated that it does not endorse appellant's position that there was a bargain sale.

As for the 2010 Appraisal, it was prepared approximately four years after the transaction, and the evidence suggests it should be given less weight. The IRS's independent appraisal also supports giving the 2010 Appraisal little to no weight because the appraisal included non-similar properties in the evaluation.

Based on the foregoing, OTA finds that appellant is not entitled to a charitable contribution deduction of any asserted value above the sales price since the sale of the Palm Springs Land was the result of a negotiated sales agreement and reflects fair market value. The fact that appellant agreed to sell the property for an amount less than what he later alleged to be the fair market value does not prove that appellant failed to receive fair market value at the time of the sale to the School District. As appellant did not sell the property to the School District for less than fair market value, the remaining donative intent requirement will not be addressed.

[14] This case is not binding on OTA and is instead cited and discussed by OTA for its persuasive value only.

OTA finds that appellant has not shown that he sold the Palm Springs Land in a bargain sale to the School District.

Issue 2: Whether appellant must recognize gain under IRC section 731.

a. Applicable Law

IRC section 1033(a) provides for the nonrecognition of gain where property has been involuntarily converted into money or unrelated property, and the taxpayer, within a certain period, acquires replacement property that is similar or related in service or use to the property so converted. Condemned real property held for productive use in trade or business, or for investment, generally can be replaced by like-kind property, which is a less restrictive standard than the similar or related in service or use requirement for other involuntary conversions. (IRC, § 1033(g)(1); Treas. Reg., § 1.1033(g)-1(a).) A taxpayer must replace condemned real property held for productive use in trade or business, or for investment, within the period beginning with the condemnation and ending three years (two years if not condemnation of real property) after the close of the first taxable year in which any part of the gain is realized. (IRC, § 1033(g)(4).) In general, gain is realized as soon as the proceeds in excess of basis are received. (*Stewart & Co. v. Commissioner* (1971) 57 T.C. 122.)

For LLCs taxable as partnerships, the partnership rules provided in Subchapter K of the IRC (IRC section 701 et seq.) govern the individual tax consequences of the LLC's members as partners.[15] When partnership property is involuntarily converted resulting in a change in a partner's share of the liabilities of the partnership and the partnership elects to defer recognition of gain under IRC section 1033, IRC sections 752 and 731 apply in determining a partner's individual tax consequences flowing from the transaction. Generally, a partner's basis in a partnership interest is equal to the partner's contributions to the partnership, plus taxable income, minus partnership losses and distributions from the partnership. (IRC, §§ 705, 733.) Under IRC section 752(b), a decrease in a partner's share of partnership liabilities is treated as a deemed distribution of money to that partner by the partnership. IRC section 731(a)(1) provides that non-liquidating distributions of money in excess of a partner's basis in the partnership interest will result in taxable gain to the partner.

[15] California generally conforms to Subchapter K through R&TC section 17851.

Where federal law and California law are the same, rulings and regulations dealing with the IRC are persuasive authority in interpreting the California statute. (*J. H. McKnight Ranch, Inc. v. Franchise Tax Bd.* (2003) 110 Cal.App.4th 978, 984, fn. 1, citing *Calhoun v. Franchise Tax Bd.* (1978) 20 Cal.3d 881, 884 and *Spurgeon v. Franchise Tax Bd.* (1984) 160 Cal.App.3d 524, 530.)

Treasury Regulation section 1.752-1(f) provides, in relevant part, that if a partner incurs both an increase in the partner's share of the partnership liabilities and a decrease in the partner's share of the partnership liabilities as a result of a *single* transaction, only the net decrease is treated as a distribution from the partnership and only the net increase is treated as a contribution of money to the partnership.

In Revenue Ruling (Rev. Rul.) 81-242, 1981-42 I.R.B. 9, a partnership's mortgaged property was involuntarily converted. As part of the conversion, the mortgage on the property was paid off. The partnership elected to defer gain under IRC section 1033 until the property was replaced. In the ruling, the IRS determined that, although gain was not recognized by the partnership in the year of the conversion, the gain had to be recognized by each partner to the extent that the partner's share of the deemed distributions arising from the payment of the mortgage exceeded the adjusted basis of the partner's interest in the partnership immediately before the deemed distribution. The IRS reasoned that the decrease in liability on the prior condemnation of the original property could not be netted against the subsequent increase in each partner's share of liability related to the replacement property. This is because the involuntary conversion of the property and later replacement of the property constituted two separate transactions that did not occur simultaneously. Therefore, the decrease in liability on the condemnation was a deemed distribution of money to the partners. (Rev. Rul. 81-242, 1981-42 I.R.B. 9.)[16]

[16] Appellant discussed Rev. Rul. 81-242, which distinguished Rev. Rul. 79-205,1979-2 C.B. 255, so that Rev. Rul. 79-205 does not apply for IRC section 1033 transactions. In Rev. Rul. 79-205, the IRS determined that non-liquidating partnership distributions to partners that included both an actual distribution of property subject to liabilities and a deemed distribution of assumed liabilities should be considered simultaneous (i.e., one transaction), resulting in the liabilities being netted. The partnership made non-liquidating distributions in a single transaction of a portion of its property to equal partners A and B. Both A and B's individual liabilities increased, but B's individual liabilities increased by a greater amount. Both A and B's share of the partnership liabilities decreased by the same amount. Since the partners' liabilities are both increasing and decreasing in the same transaction, offsetting the increases and decreases tend to limit gain recognition, which effectuates Congressional intent to limit narrowly the area in which gain or loss is recognized upon a distribution by a partnership.

b. Analysis

The sale of the Palm Springs Land reduced appellant's pro rata share of the mortgage liability of $160,490 because a portion of the sale proceeds were used to pay off the mortgage.[17] The reduction of appellant's partnership liability is a deemed distribution which decreases appellant's basis in MC Properties LLC. (IRC, § 752(b).) Because appellant's basis is lower than the amount of cash distributions received from MC Properties LLC, appellant is required to recognize gain to the extent that the gain exceeds his basis. (IRC, §731.) Pursuant to Rev. Rul. 81-242, in IRC section 1033 transactions by a partnership, the sale of relinquished property and the acquisition of replacement property are two separate transactions. Therefore, partners are not able to offset decreases in mortgage liability of the relinquished property with increases in mortgage liability of the replacement property.

Appellant contends that Rev. Rul. 81-242 should be disregarded and FTB should apply the single transaction liability netting rule provided by Treasury Regulation section 1.752-1(f). Appellant contends that Rev. Rul. 81-242 is inconsistent with the policy behind IRC section 1033. Appellant further contends that it is unfair to treat involuntary exchanges pursuant to IRC section 1033 differently from exchanges made pursuant to IRC section 1031.

Appellant contends that the sale of the Palm Springs Land and the purchase of the reinvestment property should be treated as a single transaction consistent with exchanges pursuant to IRC section 1031, citing Rev. Rul. 2003-56, 2003-23 I.R.B. 985. Rev. Rul. 2003-56 provides that if a partner's share of the replacement liability exceeds the partner's share of the relinquished liability, only the net increase in liability is taken into account for purposes of determining the increase in the partner's share of partnership liability under IRC section 752(a). The net increase is taken into account in the second taxable year of the partnership since it is attributable to the receipt of the replacement property subject to the replacement liability in that year. However, Rev. Rul. 2003-56 is limited to IRC section 1031 transactions and relies on the

[17] In addition to the relief of mortgage liabilities of $160,490, appellant received cash distributions that resulted in gain of $497,440, for a total amount of IRC section 731 gain of $657,930. The issue on appeal only relates to the $160,490 of gain related to the relief of mortgage liabilities. Appellant has not disputed receiving the remaining $497,440 of the resulted gain of cash distributions.

liability offsetting rule provided in Treasury Regulation section 1.1031(b)-1(c).[18] There is no comparable Treasury Regulation under IRC section 1033.

OTA finds the IRS's interpretation and analysis in Rev. Rul. 81-242 to be persuasive and also notes the lack of any supporting regulation for appellant's position. (See *J. H. McKnight Ranch, Inc. v. Franchise Tax Bd.*, *supra*, 110 Cal.App.4th 978.) Therefore, OTA will not net the prior and subsequent mortgages and instead treats the involuntary conversion and purchase of replacement property as two separate and distinct transactions.[19] As a result, appellant must recognize taxable gain to the extent that cash distributions from MC Properties LLC exceeds appellant's basis in MC Properties LLC, after giving effect to the reduction in his share of partnership liabilities.

Appellant contends that his basis in MC Properties LLC through his direct interest in MC Properties LLC should be increased by his pro rata share of basis through his interests in MacLeod Wolff LLC and the MacLeod Family Limited Partnership, which would reduce the amount of IRC section 731 gain recognized. Appellant cites the unitary basis rule as support for his position. The unitary basis rule provides that "a partner has a single basis in a partnership interest, even if such partner is both a general partner and a limited partner of the *same* partnership." (Rev. Rul. 84-53, 1984-15 I.R.B. 17, italics added.) Here, appellant holds a direct partner interest in MC Properties LLC. Appellant also holds partner interests in MacLeod Wolff LLC and MacLeod Family Limited Partnership, which in turn hold interests in MC Properties LLC. MacLeod Wolff LLC has two members, while MacLeod Family Limited Partnership has four partners. Since both entities have more than one member or partner, they are treated as separate taxpayers under Treasury Regulation sections 301.7701-1 through -3. The unitary basis rule only applies when a taxpayer owns multiple direct interests in the *same* partnership (i.e., taxpayer owns both a general partnership interest and a limited partnership interest in the same

[18] Treasury Regulation section 1.1031(b)-1(c) provides that where, in an exchange made pursuant to IRC section 1031(b), each party to the exchange either assumes a liability of the other party or acquires property subject to a liability, then, in determining the amount of other property or money for purposes of IRC section 1031(b), consideration given in the form of an assumption of liabilities (or a receipt of property subject to a liability) shall be offset against consideration received in the form of an assumption of liabilities (or a transfer subject to a liability).

[19] Appellant contends that attorneys at FTB, including the protest hearing officer in this appeal, acknowledge in a Tax Notes article that Rev. Rul. 81-242 results in unfair tax consequences. The Tax Notes article discusses the history of the Rev. Rul. 81-242 and proposes law changes to address the unfair tax consequences of the Rev. Rul. OTA finds that the article is of limited value as it merely proposes law changes, and it only represents the view of one attorney, rather than the view of FTB or the California Legislature.

partnership). Therefore, the unitary basis rule does not permit appellant to combine his basis in MC Properties LLC with his pro rata share portion of MacLeod Wolff LLC's and MacLeod Family Limited Partnership's basis in MC Properties LLC. The rule does not support appellant's contention which disregards MacLeod Wolff LLC and MacLeod Family Limited Partnership as separate entities. Appellant has not provided any legal authority, and OTA finds none, to expand the unitary basis rule to address the circumstances of this appeal.

Issue 3: Whether FTB's exchange of information with the IRS bars it from pursuing its proposed California tax deficiencies or force it to accept the results of federal audit and subsequent court-approved settlement based on res judicata principles.

a. Res Judicata Applicable Law

Generally

R&TC section 19802(a) provides that the rule of res judicata is applicable only if the liability involved is for the same year as was involved in another case previously determined. The doctrine of res judicata, or claim preclusion, is an affirmative defense developed by the courts to bar repetitious suits on the same cause of action, and it is applicable to tax litigation. (*Appeal of Millennium Dental Technologies, Inc.*, 2019-OTA-178P.) "Income taxes are levied on an annual basis. Each year is the origin of a new liability and of a separate cause of action. Thus, if a claim of liability or non-liability relating to a particular tax year is litigated, a judgment on the merits is res judicata as to any subsequent proceeding involving the same claim and the same tax year." (*Ibid.*) The doctrine of res judicata describes the preclusive effect of a final judgment on the merits. (*Mycogen Corp. v. Monsanto Co.* (2002) 28 Cal.4th 888, 896.) The party asserting collateral estoppel and res judicata bears the burden of establishing requirements of either type of preclusion. (*Patel v. Crown Diamonds, Inc.* (2016) 247 Cal.App.4th 29, 40.)[20]

[20] The California Supreme Court has explained that the term, "res judicata," has been used as an umbrella term including both "claim preclusion" and "issue preclusion" as two separate "aspects" of the overarching doctrine. (*DKN Holdings LLC v. Faerber* (2015) 61 Cal.4th 813, 823-824.) Claim preclusion, the "primary aspect" of res judicata, bars claims that were, or should have been, advanced in a previous suit involving the same parties. (*Ibid.*) Issue preclusion, the "secondary aspect" historically called collateral estoppel, bars relitigating issues that were argued and decided in the first suit. (*Ibid.*) Generally, courts have used the term "res judicata" to refer to claim preclusion. (*Ibid.*) On occasion, however, courts have used the term "res judicata" more broadly, even in a case involving only *issue* preclusion, or collateral estoppel. (*Ibid.*, citing *Bernhard v. Bank of America* (1942) 19 Cal.2d 807, 813.) For simplicity, the term "claim preclusion" will be used to refer to the primary aspect of res judicata and the term "issue preclusion" to refer to collateral estoppel.

Claim Preclusion

Res judicata, or claim preclusion, bars relitigation of the same cause of action in a second suit between the same parties or parties in privity with them. (*Mycogen Corp. v. Monsanto Co.*, *supra*, 28 Cal.4th at p. 896.) The application of res judicata depends upon the satisfaction of four elements: (1) the parties in each action must be identical (or at least be in privity); (2) a court of competent jurisdiction must have rendered the first judgment; (3) the prior action must have resulted in a final judgment on the merits; and (4) the same cause of action or claim must be involved in both suits (or, here, appeals). (*Appeal of Millennium Dental Technologies, Inc.*, *supra*.)

Claim preclusion bars the litigation not only of issues that were actually litigated in the prior proceeding, but also issues that could have been litigated in that proceeding. (*Franceschi v. Franchise Tax Bd.* (2016) 1 Cal.App.5th 247, 257.) The driving principle behind this doctrine is that the parties had a full and fair opportunity to litigate claims alleged in the first action. (*Guerrero v. Dept. of Corrections & Rehabilitation* (2018) 28 Cal.App.5th 1091, 1098.)

In the context of administrative tax appeals, OTA's predecessor, the State Board of Equalization (SBE), applied the basic premise of claim preclusion, rejecting a taxpayer's appeal of a refund claim after SBE ruled against the taxpayer in a prior deficiency appeal dealing with the same tax year, liability, issue, facts, and arguments. (*Appeals of Williams, et al.* (84-SBE-050) 1984 WL 16129.)

Issue Preclusion

Collateral estoppel, or issue preclusion, bars the relitigation of issues argued and decided in a previous suit, even if the second suit raises a different cause of action. (*Parklane Hosiery Co., Inc. v. Shore* (1979) 439 U.S. 322, 326.) The doctrine is inapplicable if the issues in the first suit are merely similar to the issues in the second suit. (*Fund for Animals, Inc. v. Lujan* (9th Cir. 1992) 962 F.2d 1391, 1399.) Issue preclusion applies: (1) after the final adjudication; (2) of an identical issue; (3) actually litigated and necessarily decided in the first suit; and (4) asserted against one who was a party in the first suit or one in privity with that party. (*DKN Holdings LLC v. Faerber*, (2015) 61 Cal. 4th 813, 824-825, citing *Lucido v. Superior Court* (1990) 51 Cal.3d 335, 341.) Issue preclusion can be invoked by one who is not a party to the first proceeding against a party who had a full and fair opportunity to litigate the issue in the first case but lost. (*Id*. at pp. 826-827.) The reach of issue preclusion is limited in that it can be asserted only against a party to the first lawsuit, or one in privity with a party. (*DKN Holdings LLC v. Faerber*, *supra*, 61 Cal.4th at 824, citing *Bernhard v. Bank of America* (1942) 19 Cal.2d 807, 812.) For purposes of issue preclusion, an issue is actually litigated when it is properly raised, by the pleadings or otherwise, and is submitted for determination, and is determined. (*Gottlieb v. Kest* (2006) 141 Cal.App.4th 110, 148; *Appeal of Atlanta Hockey, Inc. et. al.* (85-SBE-096) 1985 WL 15864.)

Issue preclusion has been held to be specifically applicable in tax litigation. (*Calhoun v. Franchise Tax Bd.* (1978) 20 Cal.3d 881 (*Calhoun*).)[21] To prevent vexatious litigation, SBE has applied issue preclusion on matters previously argued and decided in that forum.[22] (*Appeal of Allec* (75-SBE-004) 1975 WL 3265, citing *Bernhard v. Bank of America*, *supra,* 19 Cal.2d 807.)

<u>Same Party or in Privity Requirement</u>

A party "is one who is 'directly interested in the subject matter, and had a right to make defense, or to control the proceeding, and to appeal from the judgment." (*DKN Holdings LLC v. Faerber*, *supra*, 61 Cal.4th at pp. 825–826, citing *Bernhard v. Bank of America*, *supra*, 19 Cal.2d at 811.) A privy is one who, after rendition of the judgment, has acquired an interest in the subject matter affected by the judgment through or under one of the parties, as by inheritance, succession, or purchase. (*Cal Sierra Development, Inc. v. George Reed, Inc.* (2017) 14 Cal.App.5th 663, 672.)

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[21] *Calhoun* involved California litigation of an issue previously decided in federal courts. FTB argued that issue preclusion barred the taxpayer from relitigating an issue previously decided. There, the applicable IRC and R&TC provisions relating to the definition of gross income were nearly identical, and there existed a final federal judicial determination on the merits of the issue. The court in *Calhoun* held that the *taxpayer* was barred from relitigating the issue in state court and that the federal determination governed for state as well as federal purposes. (*Calhoun*, *supra,* 20 Cal.3d at 884, italics added.)

[22] SBE declined to apply the doctrine of issue preclusion where, in a subsequent appeal, the taxpayer brought forth more evidence than that presented in the previous appeal. (*Appeal of Berner* (2001-SBE-006A) 2002 WL 1884256.) SBE also declined to apply issue preclusion where a taxpayer had a criminal conviction as a result of a guilty plea, rather than a trial on the merits, to the same issue in a subsequent civil matter. (*Appeal of Erilane* (74-SBE-050) 1974 WL 2866.) In addition, SBE acknowledged that a taxpayer is not precluded from relitigating an issue before SBE if the federal and state law provisions are different. (*Appeal of Inglewood Park Cemetery Association Endowment Care Fund* (84-SBE-091) 1984 WL 16170.) SBE also determined that an issue is not actually litigated and determined in a prior litigation where the taxpayer and FTB's briefs in the prior litigation focused on a separate issue and only briefly mentioned the issue at hand and the court's decision does not mention the issue at hand. (*Appeal of Atlanta Hockey, Inc. et. al.* (85-SBE-096) 1985 WL 15864.)

Generally, a person who was not a party to a prior action is not bound by the judgment entered in that case, subject to certain recognized "exceptions," which collectively are sometimes referred to as establishing "privity" between the nonparty and a party to the prior action. (*Taylor v. Sturgell* (2008) 553 U.S. 880, 893; accord, *Guerrero v. Dept. of Corrections & Rehabilitation*, *supra*, 28 Cal.App.5th 1091.) Privity requires the sharing of "an identity or community of interest," with "adequate representation" of that interest in the first suit, and circumstances such that the nonparty "should reasonably have expected to be bound" by the first suit. (*DKN Holdings LLC v. Faerber*, *supra*, 61 Cal.4th 813, 826, internal citations omitted.) A nonparty alleged to be in privity must have an interest so similar to the party's interest that the party acted as the nonparty's "virtual representative" in the first action. (*Ibid*.)

The emphasis is not on a concept of identity of parties, but on the practical situation. (*Castillo v. Glenair, Inc.* (2018) 23 Cal.App.5th 262, 277.) The question is whether the non-party is sufficiently close to the original case to afford application of the principle of preclusion. (*Ibid.*) Put another way, privity does not embrace relationships between persons or entities, but rather privity deals with a person's relationship to the subject matter of the litigation. (*Ibid*.) Whether someone in the second suit is in privity with a party in the first suit requires a close examination of the facts and circumstances of each case. (*Citizens for Open Access to Sand and Tide, Inc. v. Seadrift Ass'n et al.* (1998) 60 Cal.App.4th 1053, 1070.)

Courts have found that privity can be established through derivative liability, such as a corporation and its employees, a general contractor and its subcontractors, an association of securities dealers and member agencies, and among alleged coconspirators. (*DKN Holdings LLC v. Faerber*, *supra*, 61 Cal.4th at pp. 827–828.) The nature of derivative liability so closely aligns the separate parties' interests that they are treated as identical parties. (*Ibid.*) In addition, courts have found privity exists between a party in the first proceeding and a party in the second proceeding where there is a mutual or successive relationship to the same rights of property, or to such an identification in interest of one person with another as to represent the same legal rights. (*Planning & Conservation League v. Castaic Lake Water Agency* (2009) 180 Cal.App.4th 210; *The Inland Oversight Committee v. City of San Bernardino* (2018) 27 Cal.App.5th 771.)

b. Analysis

For claim preclusion or issue preclusion to apply, appellant must demonstrate that FTB was either a party or in privity with the IRS in the federal action. FTB was not a party in the stipulated decision between appellant and the IRS. Courts have found privity where the first and second actions dealt with agencies of the same government. (*Sunshine Anthracite Coal Co. v. Adkins*, (1940) 310 U.S. 381; *Scott v. Kuhlmann* (9th Cir. 1984) 746 F.2d 1377.) Appellant seeks to extend this logic to agencies of *separate* governments – federal and state. It appears that no court has ever applied claim preclusion or issue preclusion to bar FTB in a second action against a taxpayer for a state tax liability where the taxpayer and the IRS disputed taxpayer's federal tax liability in the first action.

Appellant also contends that FTB was in privity with the IRS because FTB participated in the federal action such that the IRS represented FTB's interests. Appellant relies on the reciprocal contractual relationship authorizing FTB and the IRS to share confidential taxpayer information with the other agency. Appellant notes that FTB sent its position letter to the IRS auditor for the IRS auditor's consideration. However, OTA finds that the sharing of audit information does not rise to the level of participation required to find privity. First, the IRS and FTB do not have the same legal rights. (Cf. *Citizens for Open Access to Sand and Tide, Inc. v. Seadrift Ass'n*, *supra*, 60 Cal.App.4th 1053.) The federal action underlying this appeal sought to protect the federal government's interest in collecting federal tax. In contrast, FTB's interest is in collecting tax on behalf of this state. (Cal. Const. art. XIII, §§ 26, 27, 33; R&TC, § 17001 et seq. See U.S. Const. amend. X.) FTB had no ability to protect the state's interest in the IRS audit and settlement process, even though FTB shared information with the IRS. Rather, the IRS was pursuing its interest in collecting the correct amount of the federal tax, while FTB's interest is in collecting the correct amount of California tax. The United States Tax Court is a legislative court created under Article 1 of the United States Constitution designed to adjudicate public rights claimed against the *federal* government. (See *Ex parte Bakelite Corp.* (1929) 279 U.S. 438, 451; *Freytag v. Commissioner* (1991) 501 U.S. 868, 870.) The United States Tax Court was established by Congress to interpret and apply the IRC in disputes between taxpayers and the federal government. (*Freytag v. Commissioner*, *supra*, 501 U.S. at 891.) FTB would not be able to participate in that forum to protect the interests of this state. FTB's limited role in being able to share its views and information with the IRS does not show that FTB had an interest so similar to the IRS's interest that the IRS acted as FTB's "virtual representative" in the federal audit and subsequent outcome. Moreover, appellant has not provided any legal authority or evidence to show that the IRS had authority to settle FTB's interests in collecting the state tax liability or that the IRS represented FTB's interests. (See *City of Martinez v. Texaco Trading & Transp., Inc.* (9th Cir. 2003) 353 F.3d 758, 764.)

Appellant contends that FTB's assessment is "derivative" of the federal assessment because California conforms to federal law on the issues in this appeal. Appellant asserts that this appeal only involves the application of federal income tax laws and, therefore, there is an identity or community of interest between FTB and the IRS. Citing *Calhoun*, *supra*, 20 Cal.3d 881, appellant asserts that the determinations by the IRS that are treated the same under state and federal law should apply for California tax purposes. However, the court in *Calhoun* applied issue preclusion against the *taxpayer*, not FTB. R&TC section 18622 provides a presumption that a final federal determination is correct and that the taxpayer is required to show error in the federal determination, which is consistent with the *Calhoun* court applying issue preclusion against the taxpayer in a state action where there is a final federal determination. In contrast, there is no statutory requirement that FTB follow a final federal determination in the R&TC. In addition, unlike the circumstances in *Calhoun*, FTB's assessment here is based on FTB's independent audit and review. FTB's assessment is also consistent with the outcome of the IRS audit. Even if it were not, the IRS's settlement determination and subsequent Tax Court stipulated decision approving the settlement takes into account litigation risk factors which is not something OTA considers for purposes of determining the correct amount of tax due under the law.

Thus, OTA finds that FTB and the IRS do not share "an identity or community of interest," FTB did not have "adequate representation" of that interest in the federal determination, and the circumstances here do not rise to the level such that FTB "should reasonably have expected to be bound" by the federal determination. (*DKN Holdings LLC v. Faerber*, *supra*, 61 Cal.4th at 826.) OTA also finds no mutual or successive relationship between the IRS and FTB that would establish privity through derivative liability. As there is no privity between the IRS and FTB, appellant's arguments about the remaining elements of claim preclusion and issue preclusion will not be addressed.

Issue 4: Whether appellant has shown interest should be abated pursuant to R&TC section 19104.

Applicable Law

R&TC section 19101 provides that taxes are due and payable as of the original due date of the taxpayer's return (without regard to extension). If tax is not paid by the original due date or if FTB assesses additional tax and that assessment becomes due and payable, the taxpayer is charged interest on the resulting balance due, compounded daily. (R&TC, § 19101.) Interest is not a penalty but is merely compensation for a taxpayer's use of the money. (R&TC, § 19101(a); *Appeal of Rougeau*, 2021-OTA-335P.) There is no reasonable cause exception to the imposition of interest. (*Appeal of Rougeau*, *supra*.)

Under R&TC section 19104, FTB may abate all or a part of any interest on a deficiency to the extent that interest is attributable in whole or in part to any unreasonable error or delay committed by FTB in the performance of a ministerial or managerial act. (R&TC, § 19104(a)(1).) An error or delay can only be considered when no significant aspect of the error or delay is attributable to the appellant and after FTB has contacted the appellant in writing with respect to the deficiency or payment. (R&TC, § 19104(b)(1).)

Although the R&TC does not define what is meant by "a ministerial or managerial act," OTA looks to the comparable federal statute, IRC section 6404(e), and the regulations thereunder for guidance. (*Douglas v. State* (1948) 48 Cal.App.2d 835, 838; *(Appeal of Balch*, 2018-OTA-159P.) Treasury Regulation section 301.6404-2(b) defines these terms as follows:

> (1) A ministerial act is a procedural or mechanical act that does not involve the exercise of judgment or discretion, and that occurs during the processing of a taxpayer's case after all prerequisites to the act, such as conferences and review by supervisors, have taken place. A decision concerning the proper application of federal tax law (or other federal or state law) is not a ministerial act.
> (2) Managerial act means an administrative act that occurs during the processing of a taxpayer's case involving the temporary or permanent loss of records or the exercise of judgment or discretion relating to management of personnel. A decision concerning the proper application of federal tax law (or other federal or state law) is not a managerial act.

(Treas. Reg. § 301.6404-2(b)(1), (b)(2).)

OTA's jurisdiction for interest abatement is limited by statute to a review of FTB's determination for an abuse of discretion. (R&TC, § 19104(b)(2)(B).) To show an abuse of discretion, appellant must establish that, in refusing to abate interest, FTB exercised its discretion arbitrarily, capriciously, or without sound basis in fact or law.[23] (*Appeal of Gorin*, 2020-OTA-018P.) The mere passage of time does not establish an unreasonable error or delay. (*Ibrahim v. Commissioner*, T.C. Memo. 2011-215.) A taxing agency's decision of how and when to work on a case, based on an evaluation of its entire caseload and its workload priorities, is not a ministerial act. (*Jean v. Commissioner*, T.C. Memo. 2002-256, citing *Strang v. Commissioner*, T.C. Memo. 2001-104, and *Leffert v. Commissioner*, T. C. Memo. 2001-23.) Where the administrative record is silent regarding the actions taken on a taxpayer's matter and FTB does not come forth with evidence to show that the employees assigned to the matter or involved in its review were actively working on it, there may be no apparent basis to support FTB's determination not to abate interest, and the unsupported determination may constitute an abuse of discretion. (See *Bucaro v. Commissioner*, T.C. Memo. 2009-247.)

a. Analysis

Appellant contends that all of the interest through protest should be abated because FTB caused an unreasonable delay in the protest hearing process by deferring the protest until the conclusion of the federal determination even though FTB ultimately decided to disregard the Tax Court stipulated decision. Appellant further contends that FTB failed to follow its own published procedures regarding case development consistent with FTB Notice 2006-6.[24]

After reviewing the record, OTA finds that FTB did not commit an unreasonable error or delay in a ministerial or managerial act. Since appellant requested FTB to defer the protest until the conclusion of the federal audit, it was reasonable for FTB to agree to the deferral. Further, the record shows that FTB diligently worked on the appeal after appellant informed FTB that the

[23] FTB cites certain unitary tax cases decided by SBE for the proposition that, where FTB has discretionary authority, the taxpayer's burden of proof to show abuse of discretion is by a clear and convincing evidence standard rather than the lesser standard of a mere preponderance of the evidence. (See *Appeal of Royal Crown Cola Co*. (74-SBE-047) 1974 WL 2863; *Appeal of Browning Manufacturing Co., et. al*. (72-SBE-026) 1972 WL 2659.) These SBE cases are based on a separate statutory scheme to approximate allocation of income within and without this state as a matter of practical tax administration. (*Butler Bros. v. McColgan* (1941)17 Cal.2d 664; *McDonnell Douglas Corp. v. Franchise Tax Bd.* (1968) 69 Cal.2d 506.) OTA declines to expand this evidentiary standard to the context of interest abatement.

[24] FTB Notice 2018-1, Processing of Docketed Protests, supersedes FTB Notice 2006-6.

federal audit was complete. Despite appellant's contention that FTB failed to follow its established procedures, a review of the records suggests no such failure. As for appellant's argument that FTB failed to follow the federal determination, FTB has shown that its review and analysis of whether the federal determination impacts the state assessment included the interpretation and application of legal principles to facts. These actions are excluded from the definition of a ministerial or managerial act. (Treas. Reg. § 301.6404-2(b)(1), (b)(2).) Furthermore, appellant contributed to the delay in processing the protest after the conclusion of the federal determination, as he omitted the fact that he had settled his federal audit with the IRS. FTB had to verify the federal determination, which required FTB to request information from the IRS. Any delay by the IRS in responding to FTB's request for information has no bearing on whether FTB committed an unreasonable error or delay, particularly where, as the records show, FTB made several follow-up contacts with the IRS on the status of the requested federal information. Therefore, FTB did not abuse its discretion in denying interest abatement.

<u>Issue 5: Whether appellant has shown reasonable cause to abate the late filing penalty for the 2006 tax year.</u>

a. Applicable Law

Under R&TC section 19131, FTB imposes a late filing penalty if a taxpayer fails to file a return on or before the due date, unless it is shown that the late filing is due to reasonable cause and not due to willful neglect. (R&TC, § 19131.) Generally, an individual's tax return is due on April 15th of the following calendar year. (R&TC, § 18566.) If taxpayers file by October 15th, they receive an automatic extension and the late filing penalty is not triggered. (R&TC, § 18567; Cal. Code Regs., tit. 18, § 18567.) The penalty is computed at 5 percent of the amount of tax required to be shown on the return for every month that the return is late, up to a maximum of 25 percent. (R&TC, § 19131(a).) For purposes of calculating this penalty, the amount of tax required to be shown on the return is reduced by any timely paid tax amounts, and any credits against the tax which may be claimed on the return. (R&TC, § 19131(c).)

To establish reasonable cause for the late filing, the taxpayer must demonstrate that the failure to timely file a tax return occurred despite the exercise of ordinary business care and prudence. (*Appeal of GEF Operating, Inc.*, 2020-OTA-057P.) A taxpayer's illness may constitute reasonable cause if it can be shown that the taxpayer's illness prevented the taxpayer from filing a timely return. (*Appeal of Head and Feliciano*, 2020-OTA-127P.) A taxpayer's failure to timely file a return is not excused by the taxpayer's reliance on an agent. (*U.S. v. Boyle* (1985) 469 U.S. 241, 251-252; *Appeal of Quality Tax & Financial Services, Inc.*, 2018-OTA-130P.)

b. Analysis

The parties do not dispute that the 2006 tax return was filed late on November 29, 2007, or that FTB correctly calculated the late filing penalty. However, appellant contends that there is reasonable cause for his failure to file a timely return. While appellant contends that the tax return was filed only one month after the automatic filing extension date of October 15, 2007, OTA notes that a return filed even one day late is nevertheless untimely filed. Appellant also contends that he has a history of timely filing his returns. However, OTA notes that for the taxable year at issue, California did not have a first-time abatement program like the IRS administers.[25] In addition, appellant contends that his tax return was complex, and the illness and later death of his long-time tax preparer, contributed to the delay. However, the illness or death of the *preparer* is not reasonable cause. (*Appeal of Seaman* (75-SBE-080) 1975 WL 3564.) Appellant has a nondelegable duty to prepare and file his own tax return. (*Appeal of Quality Tax & Financial Services, Inc.*, *supra*.) Appellant has not provided evidence of his efforts to find someone else to prepare and timely file the return. Furthermore, it has been long held that complexity of returns and the difficulty of obtaining information is not reasonable cause. (*Appeal of Xie*, 2018-OTA-076P.) OTA finds that appellant has not demonstrated reasonable cause for his failure to file a timely return.

[25] Beginning with taxable year 2022, California has adopted a first-time abatement program, by statute. (R&TC, § 19132.5.) The statute does not apply retroactively such that appellant's late payment penalty may be abated.

HOLDINGS

1. Appellant has not demonstrated that he sold real property in a "bargain sale" to the School District.
2. Appellant is required to recognize gain under IRC section 731.
3. FTB's exchange of information with the IRS did not bar it from pursuing its proposed California tax deficiencies or force it to accept the results of federal audit and subsequent court-approved settlement based on res judicata principles.
4. Appellant is not entitled to interest abatement.
5. Appellant is not entitled to abatement of the late filing penalty for the 2006 tax year.

DISPOSITION

FTB's actions are sustained.

DocuSigned by:
Sara A Hosey
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Sara A. Hosey
Administrative Law Judge

We concur:

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Huy "Mike" Le
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Huy "Mike" Le
Administrative Law Judge

DocuSigned by:
Amanda Vassigh
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Amanda Vassigh
Administrative Law Judge

Date Issued: 12/23/2022