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2022 – OTA – 408P
Precedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **J. SILVER AND K. SILVER**	OTA Case No. 20116884

OPINION

Representing the Parties:

For Appellants: Menasche M. Nass, Attorney

For Respondent: Sonia Woodruff, Tax Counsel IV

For Office of Tax Appeals (OTA): Andrew Jacobson, Tax Counsel III

E. LAM, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, J. Silver (appellant-husband) and K. Silver (collectively, appellants) appeal actions by respondent Franchise Tax Board (FTB) proposing the following: additional tax of $1,145,308, a late-filing penalty of $411,327, and an accuracy-related penalty of $229,061.60, plus applicable interest, for the 2009 tax year; and additional tax of $2,648,035 and an accuracy-related penalty of $529,607, plus applicable interest, for the 2010 tax year.

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

ISSUES

1. Whether appellants have shown error in FTB's determination that appellant-husband was not "at risk" for purposes of Internal Revenue Code (IRC) section 465 and therefore was not entitled to claim pass-through losses of $10,789,917 for the 2009 tax year and $19,210,083 for the 2010 tax year.
2. Whether appellants have shown reasonable cause to abate the late-filing penalty for the 2009 tax year.

3. Whether appellants have shown the accuracy-related penalties should be abated for the 2009 and 2010 tax years.

FACTUAL FINDINGS

1. Dark Castle Holdings, LLC (Dark Castle), a limited liability company, was classified as a partnership for U.S. federal and California income tax purposes.[1] Dark Castle had at least five members during the 2009 and 2010 tax years.[2]
2. Silver Slate LLC (Silver Slate), a limited liability company, was classified as a disregarded entity for U.S. federal and California income tax purposes for the 2009 and 2010 tax years.[3] Silver Slate was a member of Dark Castle for the tax years at issue. It is undisputed that appellant-husband was the sole member of Silver Slate.
3. Silver Pictures Management, Inc. (SPM) is a California corporation. It is undisputed that appellant-husband is a shareholder of SPM and that SPM served as a vehicle for appellant-husband's personal services and other obligations as a film producer.[4]
4. Dark Castle entered into a Credit, Security, Guaranty and Pledge Agreement, dated as of September 20, 2006 (Credit Agreement),[5] as Borrower, with JP Morgan Chase Bank N.A. (J.P. Morgan Chase) as Administrative Agent and as Issuing Bank.[6] Section 8.15 of the Credit Agreement explicitly states that, "[n]o recourse shall be had for the payment of any amount owing by the Borrower or the other Credit Parties hereunder . . . arising out of or based on this Credit Agreement, against any of the following . . ." including

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[1] Appellants did not provide the LLC agreement for Dark Castle.

[2] Dark Castle's 2009 California Limited Liability Company Return of Income (Form 568) indicated none of its five members were related to each other, as defined by IRC section 267(c)(4). Appellants did not provide Dark Castle's Form 568 for the 2010 tax year.

[3] Appellants did not provide the LLC agreement for Silver Slate.

[4] Appellants also did not provide SPM's articles of incorporation. Nonetheless, FTB does not dispute the assertion that SPM elected to be taxed as an S corporation.

[5] The Credit Agreement stated that it is one of many documents entitled Fundamental Documents, which include Notes, Pledgeholder Agreements, Distribution Agreements, the Personal Guaranty, Key Man Policies, Borrower's Organizational Documents and UCC financing statements. Aside from the Credit Agreement, none of the Fundamental Documents were provided on appeal.

[6] The Credit Agreement references several other guarantors that were supposed to be listed on Schedule 3.7(a), but such schedule was not provided on appeal. FTB asserts on appeal that the Credit Agreement was subsequently amended six times from October 9, 2007, through October 17, 2011. However, no copies of these amendments have been provided on appeal.

appellant-husband, SPM, and Silver Slate, collectively known as "Non-Recourse Parties."

2009 Tax Year and the Side Letter Agreement

5. SPM, Dark Castle, and Horticus Productions, LLC (Horticus)[7]executed a side letter agreement (SLA) as of August 31, 2009, and further amended on October 22, 2009, concerning the motion picture "Unknown White Male." The opening paragraph of the SLA references two additional agreements: (1) a producer's completion agreement (PCA) dated as of August 31, 2009, between Dark Castle and Horticus (as Producer) and International Film Guarantors (IFG) and Fireman's Fund Insurance Company (FFIC); and (2) a completion guarantee agreement (CGA) also dated as of August 31, 2009, between JP Morgan Chase (as Beneficiary) and IFG and FFIC (as Guarantors).[8]
6. The SLA states in section 12 that it is to be interpreted under California law.
7. Under the SLA, SPM, Dark Castle, and Horticus agreed, among other things, to be financially responsible for costs in excess of the approved budget for the film, until such time as funded by the Beneficiary (i.e., JP Morgan Chase). The SLA states that SPM, Dark Castle, and Horticus agreed to the SLA to induce the Guarantors (i.e., IFG and FFIC) to enter into the PCA and CGA.
8. According to a 2009 California Schedule K-1, Dark Castle allocated to Silver Slate a flow through ordinary loss of $49,277,534, after California adjustments, which was reported as entirely California source income.
9. On December 27, 2010, appellants late-filed their 2009 California resident income tax return. According to an attached federal form 6198, At-Risk Limitations, appellant-husband increased his basis in Dark Castle by $10,789,917 due to "recourse loans" and claimed a pass-through loss of $10,790,017 from Dark Castle.[9]

[7] Horticus is a single member LLC that is wholly-owned by Dark Castle, according to an organizational chart in the record.

[8] The PCA and CGA were not provided on appeal. The SLA was signed by SPM, Dark Castle, and Horticus, only. There is no written acknowledgment or other record of acceptance of the SLA by IFG, FFIC, or JP Morgan Chase (the other parties to the PCA and CGA) in the appeal record. The October 22, 2009 amendment to the SLA also was not provided on appeal.

[9] A copy of appellants' 2009 federal income tax return was not provided on appeal.

10. FTB audited appellants' 2009 California return and issued a Notice of Proposed Assessment (NPA) for the 2009 tax year that denied appellants' pass-through loss in the amount of $10,789,917.[10]
11. Thereafter, FTB issued a Notice of Action (NOA) affirming the 2009 NPA, including proposed additional tax of $1,145,308, a late-filing penalty of $411,327, and an accuracy-related penalty of $229,061.60, plus applicable interest

<u>2010 Tax Year and the Guaranty Agreement</u>

12. Silver Slate, as guarantor, entered into a guaranty agreement dated as of November 30, 2010 (Guaranty), in favor of Dark Castle, as borrower.
13. The Guaranty provides that Silver Slate will guarantee an amount of up to $30 million to Dark Castle to induce the participating lenders under the Credit Agreement to permit Dark Castle to produce films under the Warner Agreement in addition to the pictures already being produced by Dark Castle.
14. The Guaranty specifically states that it is to commence or be effective from the date of January 1, 2011, through and including December 31, 2012.
15. On or about October 17, 2011, appellants filed their 2010 California resident income tax return. According to an attached federal form 6198, At-Risk Limitations, appellant-husband was allocated a total ordinary loss of $80,723,281 from Dark Castle.[11] In order to deduct part of this loss, appellant-husband treated Silver Slate's $30 million guarantee as his own "recourse" obligation and increased his basis in Dark Castle by $30 million. Appellant-husband also decreased his basis in Dark Castle by $10,789,917 (which represents, as noted above, the Dark Castle pass-through loss appellants claimed for the 2009 tax year). This resulted in a claimed ordinary loss of $19,210,083 ($30,000,000 - $10,789,917), which appellants used to offset ordinary income for 2010 tax year.[12]

[10] A copy of the 2009 NPA was not provided on appeal.

[11] The total allocated ordinary loss on the 2010 Form 6198 is $80,723,281, which was comprised of the 2010 tax year's ordinary loss of $28,603,955, and the 2009 tax year's unused carryover loss in the amount of $52,119,326.

[12] A copy of appellants' 2010 federal income tax return was not provided. On the 2010 form 6198 attachment, appellants reported the $10,789,917 loan (the 2009 tax year's at-risk amount) as "nonrecourse loans" and reduced their basis in Dark Castle by this amount.

16. FTB subsequently audited appellants' 2010 California return and issued an NPA for the 2010 tax year that denied appellants' pass-through losses of $19,210,083.[13]
17. Thereafter, FTB issued a NOA affirming the 2010 NPA, including proposed additional tax of $2,648,035 and an accuracy-related penalty of $529,607, plus applicable interest.
18. This timely appeal followed.

DISCUSSION

Issue 1: Whether appellants have shown error in FTB's determination that appellant-husband was not "at risk" for purposes of IRC section 465 and therefore was not entitled to claim pass-through losses of $10,789,917 for the 2009 tax year and $19,210,083 for the 2010 tax year.

It is well established that a presumption of correctness attends FTB's determinations of fact and that taxpayers have the burden of proving that such determinations are erroneous. (*Appeal of Head and Feliciano*, 2020-OTA-127P.) Income tax deductions are a matter of legislative grace, and a taxpayer who claims a deduction has the burden of proving by competent evidence that he or she is entitled to that deduction. (*Appeal of Vardell*, 2020-OTA-190P.) To meet that burden, a taxpayer must point to an applicable statute and show by credible evidence that the transactions in question come within its terms. (*Appeal of Jindal*, 2019-OTA-372P.) Unsupported assertions cannot satisfy a taxpayer's burden of proof. (*Appeal of Vardell*, *supra*.) A taxpayer's failure to produce evidence that is within his or her control gives rise to a presumption that such evidence, if provided, would have been unfavorable to the taxpayer's case. (*Ibid.*)

General Rules on Loss Limitations

Generally, individual taxpayers who receive losses from a partnership must satisfy three separate loss limitation rules before the loss is allowed. The loss limitation rules are applied in the following order: (1) a taxpayer can claim losses from the partnership only to the extent of the taxpayer's adjusted tax basis in the partnership under IRC section 704(d); (2) the taxpayer can claim losses only to the extent that the taxpayer is at-risk for the activity under IRC section 465; and (3) if the loss is from a passive activity, the taxpayer may claim the loss only to the extent allowed by the passive activity loss limitation rules under IRC section 469.[14]

[13] A copy of the 2010 NPA was not provided on appeal.

[14] California conforms to these IRC provisions pursuant to R&TC sections 17551(a) and 17851.

Here, there is no dispute as to the adjusted basis limitation rules and the passive activity loss limitation rules. As such, the analysis in this appeal focuses on the at-risk rules under IRC section 465.

At-Risk Rules

IRC section 465(c)(1) lists specific activities that are subject to the at-risk rules.[15] As relevant here, a taxpayer may recognize a loss from the holding, producing, or distributing of motion picture films or video tapes for a taxable year "only to the extent of the aggregate amount with respect to which the taxpayer is at risk (within the meaning of [IRC section 465] subsection (b)) for such activity at the close of the taxable year." (IRC, § 465(a)(1) & (c)(1)(A).)

IRC section 465(b)(1) provides that a taxpayer's amount at risk includes the amount of money and the adjusted basis of property that the taxpayer has contributed to the activity, as well as amounts borrowed with respect to such activity, as determined under IRC section 465(b)(2). According to IRC section 465(b)(2), a taxpayer is considered at risk with respect to amounts borrowed for use in an activity to the extent that he or she: (A) is personally liable for the repayment of such amounts; or (B) has pledged property, other than property used in such activity, as security for such borrowed amount (to the extent of the net fair market value of the taxpayer's interest in such property). Additionally, IRC section 465(b)(4) provides that notwithstanding any other provision of IRC section 465, a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.

Appellants do not contend that they contributed money or property to Dark Castle during the 2009 or 2010 tax years, and there is no evidence to suggest that appellants pledged property as security for Dark Castle's obligations. Rather, appellants contend that they are at risk with respect to Dark Castle for the 2009 and 2010 tax years because they are the "obligor of last resort who . . . would be personally liable for all amounts owed under the [2006 Credit Agreement, the 2009 SLA, and 2010 Guaranty]." Therefore, as discussed below, the issue on appeal is: (1) whether appellants are personally liable for the repayment of Dark Castle's obligations under

[15] Although the rules include a list of specific activities like film production and oil and gas exploration, the rules generally apply more broadly to any "activity engaged in by the taxpayer in carrying on a trade or business or for the production of income . . ." (IRC, § 465(c)(3)(A); see Pub.L. No. 95-600 (Nov. 6, 1978) 92 Stat. 2763, Title II, § 201.)

these agreements; and if so, (2) whether they are not otherwise protected against loss. (IRC, §§ 465(b)(2)(A), 465(b)(4).)

To determine whether a taxpayer is personally liable under IRC section 465(b)(2)(A), the inquiry is "who is the obligor of last resort, and in determining who has the ultimate economic responsibility for the loan, the substance of the transaction controls." (*Pritchett v. Commissioner* (9th Cir. 1974) 827 F.2d 644, 647.) The relevant question is:

> who, if anyone, will ultimately be obligated to pay the partnership's recourse obligations if the partnership is unable to do so. It is not relevant that the partnership MAY be able to do so. The scenario that controls is the worst-case scenario, not the best case. Furthermore, the fact that the partnership or other partners remain in the "chain of liability" should not detract from the at-risk amount of the parties who do have the ultimate liability. (*Melvin v. Commissioner* (1987) 88 T.C. 63, 75, affd. (9th Cir. 1990) 894 F.2d 1072.)

In *Melvin v. Commissioner*, *supra*, the limited partners had the obligation to make deferred capital contributions to a partnership if the partnership were unable to repay a loan to the bank. (*Ibid.*) The tax court determined that the limited partners were personally liable within the meaning of IRC section 465(b)(2)(A) because the limited partners' "deferred capital contributions were to serve as the ultimate source of the proceeds for the repayment of the bank loan. . . ." (*Id*. at pp. 76-77.) Also, "if the bank proceeded directly against the limited partners to collect the loan, the limited partners would have no right of reimbursement from [the partnership] or general partners . . . ." (*Id*. at p. 77.) As a result, the tax court, applying this "obligor of last resort" test, concluded that the limited partners were personally liable for this partnership debt for purposes of IRC section 465(b)(2)(A) since it was "independent, fixed, and definite" recourse obligation for which the limited partners were personally liable as the obligor of last resort. (*Ibid.*)

If a taxpayer is found to be personally liable under the "obligor of last resort" test for purposes of IRC section 465(b)(2)(A), the taxpayer may still not be considered at risk if he or she is otherwise protected from loss. More specifically, IRC section 465(b)(4) provides that "a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements." For example, a partner of a partnership is protected against loss if the partner has rights of subrogation or contribution against the partnership or any other partner. (*Melvin v. Commissioner*, *supra*, 88 T.C. at p. 70.)

While federal courts consistently apply the "obligor of last resort" test for purposes of determining a taxpayer's personal liability for repayment of borrowed amounts under IRC section 465(b)(2)(A), there is a split in the Federal Courts of Appeal regarding the test to be used in determining whether a taxpayer is otherwise protected from loss as contemplated by IRC section 465(b)(4). The Ninth Circuit, as well other federal circuit courts,[16] the United States Tax Court,[17] and the IRS,[18] employ an additional "economic realities" test to determine whether a financial arrangement removes any realistic possibility of economic loss under IRC section 465(b)(4). In discussing the economic realities test, the Ninth Circuit stated:

> [T]he purpose of subsection 465(b)(4) is to suspend at risk treatment where a transaction is structured—by whatever method—to remove any realistic possibility that the taxpayer will suffer an economic loss if the transaction turns out to be unprofitable. [Citation omitted.] A theoretical possibility that the taxpayer will suffer economic loss is insufficient to avoid the applicability of this subsection. We must be guided by economic reality. (*American Principals Leasing Corp. v. United States* (9th Cir. 1990) 904 F.2d 477, 483.)

In contrast, the Sixth Circuit applies the same "obligor of last resort" test both for the purpose of determining a taxpayer's personal liability for repayment of borrowed amounts under IRC section 465(b)(2)(A) and for the purpose of determining whether the taxpayer is protected from economic risk of loss under IRC section 465(b)(4).[19] However, whether OTA applies the "economic realities" test or the "obligor of last resort" test for purposes of IRC section 465(b)(4) is not pertinent in this appeal because OTA finds that appellants have not satisfied their burden of proving that they are the personally liable for repayment of the borrowed amounts for purposes of IRC section 465(b)(2)(A).

On appeal, appellants contend that they were at risk with respect to Dark Castle for: (1) the 2009 tax year because appellant-husband was personally liable for Dark Castle's obligations under the SLA; (2) the 2010 tax year because of the Guaranty was executed by

[16] The federal Second Circuit, Third Circuit, Eighth Circuit, and Eleventh Circuit apply the economic realities test in deciding whether the taxpayer is protected from loss as contemplated by IRC section 465(b)(4). (See *Waters v. Commissioner* (2d Cir. 1992) 978 F.2d 1310, 1316; *Nicholson v. Commissioner* (3d Cir. 1995) 60 F.3d 1020, 1027; *Oren v. Commissioner* (8th Cir. 2004) 357 F.3d 854, 859; *Young v. Commissioner* (11th Cir. 1991) 926 F.2d 1083, *aff'g* T.C. Memo. 1988-440.)

[17] See e.g., *Levien v. Commissioner* (1994) 103 T.C. 120, 129.

[18] CCA 201308028 (IRS Chief Counsel's Office concluded that the "economic realities" test is the appropriate test to apply to determine whether an LLC member that guarantees LLC debt is protected from loss).

[19] See e.g., *Martuccio v. Commissioner* (6th Cir. 1994) 30 F.3d 743.

appellant-husband through Silver Slate; and (3) the 2009 and 2010 tax years because appellant-husband was personally liable for Dark Castle's obligations under the Credit Agreement or through an alter ego theory. Each of these arguments is addressed in turn.

2009 Tax Year and the SLA

The SLA provides that SPM, Dark Castle, and Horticus were responsible to pay for cost overruns related to cast salaries and other items. According to section 10 of the SLA, in the event SPM, Dark Castle, or Horticus default, it was IFG and FFIC that served as guarantors to JP Morgan Chase, and IFG and FFIC in turn has recourse against SPM, Dark Castle, and Horticus.[20]

Appellants assert that appellant-husband was ultimately responsible for the liabilities under the SLA for the 2009 tax year because: (1) appellant-husband was the shareholder of SPM, which is the entity that entered into the SLA;[21] and (2) appellant-husband was ultimately responsible for the liabilities of Dark Castle, which was the entity that entered into the SLA as one of the producers. Appellants further contend that since "the entities [i.e., SPM or Dark Castle] could not have carried out their functions or fulfilled their contractual obligations without [appellant-husband]" and given that "the ultimate source of repayment for the enumerated items under the SLA was [appellant-husband]," this should give rise to a finding that appellant-husband was personally at risk for the obligations under the SLA because he was the obligor of last resort.

OTA does not find appellants' first argument, that appellant-husband's ownership of SPM demonstrates that he was at risk in Dark Castle (an unrelated entity from SPM) for the 2009 tax year, to be convincing. According to the at-risk rules, the loss will be allowed to the extent that the taxpayer has at-risk basis in that specific *activity*. (See IRC, § 465(c)(3)(B).) In this appeal, appellants deducted 2009 losses from Dark Castle, through Silver Slate, on their personal income tax return. Therefore, the issue is whether appellant-husband was at risk with respect to Dark Castle, not SPM, for the 2009 tax year. The record shows that SPM is appellant-husband's corporation that served as a vehicle for appellant-husband's personal services and other

[20] SLA section 10 allows IFG and FFIC to recover from SPM, Dark Castle, and Horticus funds necessary to finish the film "Unknown White Male" following a breach of the SLA, as well as to recover collection costs.

[21] Appellants initially assert that appellant-husband entered into the SLA "through Silver Slate." However, Silver Slate is not a party to the SLA. Therefore, OTA regards this as a misstatement of appellants' position and instead believes appellants meant that appellant-husband entered into the SLA through SPM.

obligations. On the other hand, Dark Castle is an unrelated entity from SPM, which operated as a film producer. Therefore, based on the evidence in the record, both activities are considered separate from each another. As such, appellants must demonstrate, but have failed on appeal to establish that SPM's and Dark Castle's activities should be aggregated as one activity for the purposes of applying the at-risk rules.[22] (See IRC, §§ 465(c)(3)(B), 465(c)(2)(A)(i).) In any event, even if appellants were able to establish that SPM's and Dark Castle's activities were aggregated as a single activity for purposes of applying the at-risk rules, appellants have not provided any evidence to suggest that appellant-husband was the alter ego of SPM or otherwise would be personally liable for SPM's corporate liabilities.[23] While appellant-husband signed the SLA on behalf of Dark Castle and SPM, there is no language in the SLA to indicate that appellant-husband is a party to the SLA or personally guaranteed any liability on behalf of any party to the SLA. Therefore, OTA does not find that appellant-husband's ownership of SPM demonstrates that he is at risk for Dark Castle's obligations.

In response to appellants' second argument, OTA does not find that appellant-husband personally guaranteed Dark Castle's obligations under the SLA or provided any evidence establishing appellant-husband had an "independent, fixed, and definite" obligation to pay any amounts under the SLA as the obligor of last resort. (*Melvin v. Commissioner*, *supra*, 88 T.C. at p. 77.) To reiterate, appellant-husband, individually, is not a party to the SLA, and appellants have not provided any evidence that appellant-husband personally guaranteed any of the liabilities incurred by Dark Castle under the SLA. [24]

Appellants also rely on IRS Office of Chief Counsel Memorandum (CCM) 201606027 (October 23, 2015), but the CCM specifically states that it is not to be cited as precedential authority. In any event, the CCM is factually distinguishable. In the CCM, an individual

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[22] Appellants also have failed to establish that Silver Slate's and Dark Castle's activities should be aggregated as a single activity. (See IRC, §§ 465(c)(3)(B), 465(c)(2)(A)(i).) Furthermore, appellants also did not produce any evidence (e.g., a cash call provision within the LLC agreement or a personal guarantee agreement) to suggest that Silver Slate would be liable for Dark Castle's debts and that appellants would personally be liable for Silver Slate's debts in the event of a default arising from the SLA.

[23] It is noted that appellants did not provide the articles of incorporation for SPM. SPM is not a member of either Dark Castle or Silver Slate. A corporation is regarded as a legal entity, separate and distinct from its stockholders, officers and directors, with separate and distinct liabilities and obligations. (*Sonora Diamond Corp. v. Superior Court* (2000) 83 Cal.App.4th 523, 538.)

[24] Appellants have not argued that appellant-husband ever executed a personal guaranty instrument, nor have they ever provided a copy of such a document. Also, appellants never provided OTA a copy of the LLC agreements for Dark Castle or Silver Slate that would suggest any personal obligations for appellants.

member personally guaranteed debts of the LLC in the event that the LLC was unable to pay its debts when due. In this appeal, appellants did not produce any evidence that appellant-husband personally guaranteed any obligation under the SLA.

Appellants further cite to an article related to "bad boy clauses," under which an LLC member may be considered personally liable if the member signed a conditional guarantee that applied only in the event certain contingencies like fraud or bankruptcy occurred. OTA does not find this analogy particularly helpful. Appellants have not pointed to any language in the SLA that could be construed as a "bad boy guarantee," nor have they established that appellant-husband signed a personal conditional guarantee.

For the above reasons, appellants have not established that appellant-husband was at risk for Dark Castle's obligations during the 2009 tax year under the SLA and, therefore, appellants are not entitled to a pass-through loss deduction of $10,789,917 for the 2009 tax year.

2010 Tax Year and the Guaranty

Appellants argue that appellant-husband was liable as a guarantor for the loan to Dark Castle for 2010 tax year as a result of the Guaranty. The Guaranty provides that Silver Slate will guarantee an amount of up to $30 million to Dark Castle for the purpose of inducing the participating lenders under the Credit Agreement to permit Dark Castle to produce films under the Warner Agreement, in addition to the pictures already being produced by Dark Castle.

However, the Guaranty specifically states that it will commence on January 1, 2011. IRC section 465(a) states that a taxpayer must be at risk with respect to an activity at the end of each taxable year. (See also *Melvin v. Commissioner*, *supra*.) On December 31, 2010, the end of the 2010 tax year, the Guaranty was not yet in effect. OTA finds this fact dispositive. Neither Silver Slate, nor appellant-husband were at risk under the Guaranty for the 2010 tax year.

For this reason, appellants have not established that appellant-husband was at risk for Dark Castle's obligations during the 2010 tax year as a result of the Guaranty and, therefore, appellants are not entitled to a pass-through loss deduction of $19,210,083 for the 2010 tax year.

2009 and 2010 Tax Years and the Credit Agreement

Appellants assert that appellant-husband was at risk as a borrower or guarantor under the Credit Agreement for both the 2009 and 2010 tax years. The purpose of the Credit Agreement

was to secure a five-year revolving credit line for Dark Castle as borrower to finance the entire production costs for each qualifying picture.

However, appellants have failed to establish that appellant-husband was the obligor of last resort under the Credit Agreement, either individually or through any other entities in this matter. In fact, the Credit Agreement specifically states in section 8.15, that "[n]o recourse shall be had for the payment of any amount owing by the Borrower or the other Credit Parties hereunder…arising out of or based on this Credit Agreement, against any of the following (collectively, the 'Non-Recourse Parties'): . . . [appellant-husband], [SPM], SPI, [Silver Slate], and each of their respective members and their affiliates. . . ." In addition, appellants have not provided Dark Castle's LLC agreement on appeal, or any other document that would establish appellants were personally liable through their interest in Dark Castle. Accordingly, because appellant-husband, SPM, and Silver Slate are specifically defined as *non-recourse* parties, and because appellants have not provided any evidence indicating they were personally liable for Dark Castle's obligations, OTA finds that appellants have not established by credible evidence that appellants were personally liable under the Credit Agreement during the 2009 and 2010 tax years.

Appellants' Alter Ego Theory

Finally, appellants further argue that they were personally liable because appellant-husband is the alter ego of "his entities." Specifically, appellants assert that "Dark Castle and Silver Slate were fully aware that [appellant-husband] was the sole controlling member of the entities" and that "the lenders considered [appellant-husband] and his entities to be alter egos of each other." Therefore, appellants argue that the lenders would have proceeded personally against appellant-husband to satisfy Dark Castle, Silver Slate, or SPM's contractual obligations by advancing an alter ego action by which appellant-husband would be the obligor of last resort.[25]

Alter ego liability is the idea that an entity may be disregarded such that the owners of the entity are personally liable for the entity's debts. There are specific elements that must be satisfied for a court to pierce the veil and hold individual shareholders liable for the actions of

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[25] We note that appellants have failed to provide an LLC agreement for Dark Castle, articles of incorporation for SPM, or an LLC agreement for Silver Slate.

the corporation. For example, in a corporate setting, in order to hold shareholder liable for the actions of the corporation, the shareholder must have treated the corporation as their "alter ego," rather than as a separate entity—meaning, there must be such unity of interest and ownership that the individuality or separateness of the corporation and individual has ceased to exist (or never existed in the first place). (*Mesler v. Bragg Mgmt. Co.* (1985) 39 Cal.3d 290, 299.) In practice, courts regard the alter ego doctrine as a drastic remedy and only disregard the corporate form in rare cases.[26] This is because the general rule is that a corporation is a legal entity separate from its owners and the law specifically allows owners to form an entity for the sole purpose of protecting themselves from liability. (*Eleanor Licensing LLC v. Classic Recreations LLC* (2018) 21 Cal.App.5th 599.) Here, appellants concede that it is uncertain or "not knowable" whether the creditors would prevail in an alter ego action. Additionally, appellants have not provided any evidence to support their position that appellant-husband and the entities in question were alter egos of each other (e.g., fraud, bad faith, commingling of personal and corporate assets, etc.).

Issue 2: Whether appellants have shown reasonable cause to abate the late-filing penalty for the 2009 tax year.

When FTB imposes a penalty, the law presumes that the penalty was imposed correctly. (*Appeal of Xie*, 2018-OTA-076P.) The burden of proof is on the taxpayer to show that reasonable cause exists to support an abatement of the late-filing penalty. (*Ibid*.) To overcome the presumption of correctness that attaches to the penalty, a taxpayer must provide credible and competent evidence supporting a claim of reasonable cause; otherwise, the penalty cannot be abated. (*Ibid*.)

R&TC section 19131 imposes a late-filing penalty on a taxpayer who fails to file a return by either the due date or the extended due date, unless it is shown that the failure was due to reasonable cause and not willful neglect. To establish reasonable cause, the taxpayer must show that the failure to file a timely return occurred despite the exercise of ordinary business care and prudence, or that such cause existed as would prompt an ordinarily intelligent and prudent businessperson to have so acted under similar circumstances. (*Appeal of Head and Feliciano*, *supra*.)

[26] "Alter ego is an extreme remedy, sparingly used." (*Sonora Diamond Corp. v. Superior Court*, *supra*, 83 Cal.App.4th at p. 539.)

Here, appellants have neither argued nor provided any evidence showing that reasonable cause exists for the late filing of their 2009 California return. Therefore, the late-filing penalty cannot be abated.

Issue 3: Whether appellants have shown the accuracy-related penalties should be abated for the 2009 and 2010 tax years.

Except as otherwise provided, California incorporates IRC sections 6662 and 6664, relating to the imposition of accuracy-related penalty on underpayments. (R&TC, § 19164(a)(1)(A) & (d)(1); *Appeal of Daneshgar*, 2021-OTA-210P.) As relevant here, the accuracy-related penalty applies to the portion of the underpayment of tax attributable to any substantial understatement of income tax. (IRC, § 6662(b)(2).) An "understatement" of tax is defined as the excess of the amount of tax required to be shown on the tax return for the taxable year, less the amount of tax imposed which is shown on the return, reduced by any rebate. (IRC, § 6662(d)(2)(A)(i)-(ii).) For individual taxpayers, an "understatement" constitutes a "substantial understatement" if the amount of the understatement exceeds the greater of $5,000, or 10 percent of the tax required to be shown on the return. (IRC, § 6662(d)(1)(A)(i)-(ii).)

In determining whether there is a substantial understatement, the taxpayer may exclude that portion of the understatement attributable to: (1) the tax treatment of any item for which there is or was substantial authority for such treatment; or (2) any item for which the relevant facts affecting the item's tax treatment were adequately disclosed in the tax return (or in a statement attached to the return), and for which there is a reasonable basis for the tax treatment of such item. (IRC, § 6662(d)(2)(B)(i)-(ii).) In addition, "[n]o penalty shall be imposed under [IRC] section 6662 . . . with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion." (R&TC, § 19164(d)(1); IRC, § 6664(c)(1).)

Here, the accuracy penalty was properly imposed for the 2009 and 2010 tax years because the additional tax proposed for these tax years (i.e., $1,145,308 and $2,648,035, respectively) exceeds both $5,000 and 10 percent of the tax (i.e., $173,574 and $264,803.50, respectively) required to be shown on the returns for these tax years,[27] resulting in substantial

[27] For the 2009 tax year, the amount of tax required to be shown on the return was $1,735,740, but appellants only reported $590,432 of tax on the original tax return. For the 2010 tax year, the amount of tax required to be shown on the return was $2,648,035 but appellants reported no taxes on the original tax return.

understatements of tax under IRC section 6662(d)(1)(A). Furthermore, appellants have neither argued nor provided any evidence showing that: (1) there is substantial authority for the treatment of the pass-through losses from Dark Castle on their 2009 or 2010 California returns; (2) appellants adequately disclosed the relevant facts affecting the reported increases in at-risk basis in Dark Castle during the 2009 and 2020 tax years; or (3) reasonable cause exists for abating the accuracy-related penalties for either the 2009 or 2010 tax year. Therefore, appellants have provided no grounds for the abatement of the accuracy-related penalties.

HOLDINGS

1. Appellants have not shown error in FTB's determination that appellant-husband was not "at risk" for purposes of IRC section 465 and appellants therefore were not entitled to claim pass-through losses of $10,789,917 for the 2009 tax year and $19,210,083 for the 2010 tax year.
2. Appellants have not shown reasonable cause to abate the late-filing penalty for the 2009 tax year.
3. Appellants have not shown the accuracy-related penalties should be abated for the 2009 and 2010 tax years.

DISPOSITION

FTB's actions are sustained.

DocuSigned by:
Eddy Y.H. Lam
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Eddy Y.H. Lam
Administrative Law Judge

We concur:

DocuSigned by:
Ovsep Akopchikyan
88F35E2A835348D...
Ovsep Akopchikyan
Administrative Law Judge

DocuSigned by:
Kenneth Gast
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Kenneth Gast
Administrative Law Judge

Date Issued: 7/13/2022