

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:

M. IOANE AND
S. IOANE

) OTA Case No. 19024366
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OPINION

Representing the Parties:

For Appellants:

M. Ioane

For Respondent:

Eric A. Yadao, Tax Counsel III

For Office of Tax Appeals:

Linda Frenklak, Tax Counsel V

H. LE, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, M. Ioane and S. Ioane (appellants) appeal actions by respondent Franchise Tax Board (FTB) proposing: additional tax of \$481,199.00 and a 40 percent accuracy-related penalty of \$192,479.60, plus applicable interest, for the 2002 tax year;¹ and additional tax of \$29,146.00 and a 20 percent accuracy-related penalty of \$5,829.20, plus applicable interest, for the 2003 tax year.²

Appellants waived their right to an oral hearing; therefore, Office of Tax Appeals (OTA) decides this matter based on the written record.

ISSUES

1. Whether the proposed assessments of additional tax for the 2002 and 2003 tax years, each of which is based on federal adjustments, are barred by the statute of limitations, and if

¹ As discussed below, FTB concedes on appeal to reduce the 2002 accuracy-related penalty from 40 percent of the proposed additional tax (\$192,479.60) to 20 percent of the proposed additional tax (\$96,239.80).

² For both proposed assessments, FTB concedes on appeal to abate interest for both the 2002 and 2003 tax years for the period December 29, 2014, through July 16, 2018.

not, whether appellants have established error in the proposed assessments of additional tax.

2. Whether appellants are entitled to abatement of the accuracy-related penalties for the 2002 and 2003 tax years.

FACTUAL FINDINGS

2002 and 2003 California Returns

1. Appellants timely filed a California Resident Income Tax Return for the 2002 tax year. Appellants reported a zero-tax liability.
2. Appellants timely filed a California Nonresident or Part-Year Resident Income Tax Return for the 2003 tax year. Appellants reported a zero-tax liability.

2002 and 2003 Tax Year Federal Returns, Adjustments, and Appeals

3. Appellants filed federal income tax returns for the 2002 and 2003 tax years. The IRS subsequently increased appellants' reported 2002 and 2003 taxable income, assessed additional taxes for both tax years, and imposed accuracy-related penalties for both tax years.
4. On May 24, 2006, appellants filed a petition with the United States Tax Court concerning the 2002 and 2003 tax years federal tax assessments. In its decision entered on June 16, 2009, the United States Tax Court stated that appellants resided in Nevada when they filed their petition with the United States Tax Court. The United States Tax Court affirmed the federal tax deficiencies and penalties for 2002 and 2003 tax years, except that, as conceded by the IRS, appellants were not liable for taxes on unreported interest income of \$1,060.26 and \$18.00 for the 2002 and 2003 tax years, respectively. The United States Tax Court found that the IRS properly imposed the accuracy-related penalties for both years because appellants' underpayment of tax resulted from negligence and substantial understatement of income.³
5. Appellants appealed the United States Tax Court's decision to the Ninth Circuit Court of Appeals.

³ In addition, the United States Tax Court imposed a penalty of \$10,000 pursuant to Internal Revenue Code section 6673(a)(1) based on its finding that appellant-husband was "uncooperative in the stipulation process," his behavior during the proceedings were "marked by a lack of candor," and his arguments were "nothing but frivolous and groundless."

6. The Ninth Circuit Court of Appeals affirmed the United States Tax Court’s decision on February 14, 2012.

FTB’s Audit and Proposed Assessments

7. FTB obtained information from the IRS regarding the federal adjustments to appellants’ 2002 and 2003 tax years federal returns and appellants’ petition in the United States Tax Court.
8. In response to an FTB inquiry, appellants provided FTB with a copy of the IRS Revenue Agent Report (RAR) regarding the 2002 and 2003 tax years.
9. Based on the 2002 and 2003 tax years federal adjustments, FTB issued to appellants Notices of Proposed Assessment (NPAs) dated September 3, 2009, for 2002 and 2003.
10. Appellants’ federal account transcripts for the 2002 and 2003 tax years contain entries under transaction code 560 that state “IRS can assess tax until 02-08-2010.”
11. The 2002 tax year NPA increased appellants’ taxable income by \$5,193,634.00 from \$21,935.00 to \$5,215,569.00, including, among other items, the unreported interest income of \$1,060.00 listed on the RAR. The 2002 tax year NPA proposed additional tax of \$481,298.00 and imposed a 40 percent accuracy-related penalty of \$192,519.20, plus interest.
12. The 2003 tax year NPA increased appellants’ reported taxable income by \$1,257,316.00 from \$11,688.00 to \$1,269,004.00, which did not include the unreported interest income of \$18.00 listed on the RAR. The 2003 tax year NPA proposed additional tax of \$29,146.00 and imposed a 20 percent accuracy-related penalty of \$5,829.20, plus interest.
13. Appellants protested the 2002 and 2003 tax year NPAs.
14. In an August 3, 2010 preliminary position letter, FTB’s hearing officer recommended modifying the 2002 tax year NPA to exclude the unreported interest income adjustment pursuant to the United States Tax Court decision and to affirm the 2003 tax year NPA, which did not include the unreported interest income.
15. Later, appellants informed FTB that they filed an appeal with the Ninth Circuit Court of Appeals from the United States Tax Court’s decision and produced copies of the briefs that they filed with the Ninth Circuit Court of Appeals.

16. On June 28, 2011, the hearing officer notified appellants that FTB was deferring their 2002 and 2003 tax year protests pending the outcome of appellants' appeal with the Ninth Circuit Court of Appeal.
17. Appellants did not report to FTB the outcome of appellants' appeal with the Ninth Circuit Court of Appeal.
18. FTB subsequently requested and received copies of appellants' 2002 and 2003 tax years master file transcripts from the IRS dated May 23, 2018. The master file transcripts showed the February 2014 conclusions of the federal examinations, with no change to the IRS's original 2002 and 2003 tax year assessments, except for the removal of the unreported income adjustment of \$1,060 and \$18 for the 2002 and 2003 tax years, respectively.
19. On July 17, 2018, FTB notified appellants that it ended the deferral of their 2002 and 2003 tax year protests because the Ninth Circuit Court of Appeals had affirmed the United States Tax Court's decision. FTB advised appellants that it was prepared to affirm its initial recommendations, as reflected in the August 3, 2010 preliminary position letter, with the modifications for the unreported interest income adjustment for the 2002 tax year. FTB also stated that, if appellants wished to substantiate their position that they were not California residents during 2002, they should produce evidence by no later than August 18, 2018.
20. Subsequently, appellants requested two 60-day extensions to locate the requested documents.
21. Appellants then sent to FTB a copy of a completed Change of Address form signed by appellants on August 1, 2003, listing an address in Reno.
22. After appellants failed to produce evidence on the California residency issue for the 2002 tax year, FTB issued Notices of Action (NOAs) dated January 23, 2019, for the 2002 and 2003 tax years. The 2002 tax year NOA modified the 2002 tax year NPA by removing the unreported interest income adjustment of \$1,060.00, resulting in a revised proposed tax of \$481,199.00 and a revised 40 percent accuracy-related penalty of \$192,479.60. The 2003 tax year NOA affirmed the 2003 tax year NPA in its entirety.
23. Appellants filed this timely appeal.

DISCUSSION

Issue 1: Whether the proposed assessments of additional tax for the 2002 and 2003 tax years, each of which is based on federal adjustments, are barred by the statute of limitations, and if not, whether appellants have established error in the proposed assessments of additional tax.

Statute of Limitations

In general, FTB must mail a proposed assessment within four years of the date the taxpayer files his or her California return. (R&TC, § 19057(a).) However, there is a special statute of limitations when federal waivers are involved. If a taxpayer agrees with the IRS to extend the federal statute of limitations, the period for mailing a notice of a proposed deficiency shall be the later of four years after the return was filed or six months after the date of the expiration of the agreed period for assessing deficiencies in the federal income tax. (R&TC, § 19065.)

Here, appellants' federal account transcripts for the 2002 and 2003 tax years contain entries that state the "IRS can assess tax until 02-08-2010." These entries were made under the transaction code 560, which means "Waiver Extension of Date Assessment Statute Expires." (IRS, Transaction Codes Pocket Guide, Document 11734 (May 2012).)⁴ This entry shows that appellants have signed a federal waiver to extend the federal statute of limitations to February 8, 2010. Under R&TC section 19065, FTB has until six months after February 8, 2010, or August 8, 2010,⁵ to mail its proposed deficiency to appellants. Since FTB mailed its 2002 and 2003 tax year NPAs on September 3, 2009, FTB's NPAs were timely mailed within the statute of limitations and nothing in OTA's records would prove a different outcome.

Proposed Assessments

R&TC section 18622(a) provides that a taxpayer shall either concede the accuracy of a federal determination or state wherein it is erroneous. A deficiency assessment based on a federal audit report is presumptively correct, and the taxpayer bears the burden of proving that

⁴ Available at https://www.irs.gov/pub/irs-utl/transaction_codes_pocket_guide.pdf.

⁵ August 8, 2010 is later than four years after appellants' returns were filed on June 15, 2003, and April 13, 2004, for the 2002 and 2003 tax years, respectively.

the determination is erroneous. (*Appeal of Gorin*, 2020-OTA-018P.) Unsupported assertions are not sufficient to satisfy a taxpayer’s burden of proof. (*Ibid.*)

Here, FTB’s proposed assessments for the 2002 and 2003 tax years are based on federal determinations. Prior to this OTA appeal, the United States Tax Court held that appellants were liable for the 2002 and 2003 tax years federal determinations, including, among other issues, liability for tax on unreported income, and no entitlement to various deductions and exemptions. The United States Tax Court also imposed an accuracy-related penalty, attributable to both negligence and a substantial understatement of income, and noted that the IRS conceded a proposed assessment of unreported interest income for both years.⁶ Subsequently, the Ninth Circuit Court of Appeals affirmed the United States Tax Court’s decision. Other than the United States Tax Court’s removal of the unreported interest income adjustments for both years, the 2002 and 2003 tax years federal determinations were not withdrawn, modified, or cancelled. Appellants have not submitted evidence to meet their burden of proving error in the federal determinations on which FTB based its 2002 and 2003 tax years’ proposed assessments. Furthermore, as discussed below, appellants have failed to establish that FTB’s proposed assessments for the 2002 or 2003 tax years are erroneous. Accordingly, appellants have not met their burden of proof for proving the determination erroneous.

2002 Residency

California residents are taxed upon their entire taxable income (regardless of source), whereas nonresidents are only taxed on income from California sources. (R&TC, §§ 17041(a), (b) & (i), 17951(a).) Part-year residents are taxed on their entire taxable income earned while residents of this state, as well as all income derived from California sources while nonresidents. (R&TC, § 17041(b) & (i).) California defines a “resident” as including: (1) every individual who is in California for other than a temporary or transitory purpose; and (2) every individual domiciled in California who is outside California for a temporary or transitory purpose. (R&TC, § 17014(a)(1)-(2); see also Cal. Code Regs., tit. 18, § 17014.) FTB’s determination of residency is presumptively correct, and the taxpayer bears the burden of showing error in FTB’s determination. (*Appeal of Mazer*, 2020-OTA-263P.)

⁶ FTB did not include this interest income in either of its NOAs.

With respect to the 2002 tax year proposed assessment, appellants contend that FTB improperly treated them as California residents for tax purposes, even though FTB's records show that appellants filed a 2002 tax year California resident return. Appellants have failed to produce requested documents substantiating their position that they were not California residents during 2002. Appellants assert that their 2002 tax year California resident return, which they filed on June 15, 2003, lists a Nevada address and that they submitted to FTB a change of address notice in 2003, listing a Nevada address. However, even if this is the case, it would not establish that appellants were California nonresidents during 2002. FTB accepts that appellants were California nonresidents during 2003.

Furthermore, there is no evidence supporting appellants' assertion that the United States Tax Court found them to be Nevada residents during the 2002 and 2003 tax years. The United States Tax Court opinion states, "At the time they filed their petition [on May 24, 2006], petitioners, who are husband and wife, resided in Nevada." However, it is not relevant to this appeal whether appellants were residents of Nevada in 2006. Appellants have not met their burden of establishing that they were not California residents during 2002. Accordingly, FTB properly determined that their entire taxable income for the 2002 tax year was subject to California tax.

Bankruptcy

Appellants assert that they filed for bankruptcy. However, OTA lacks subject matter jurisdiction to address whether a taxpayer's proposed assessment was discharged in bankruptcy. (Cal. Code Regs., tit. 18, § 30104(h); *Appeal of Savage*, 2020-OTA-328P.) Accordingly, OTA does not address the effect of any bankruptcy proceeding on the collectability of appellants' 2002 or 2003 tax years' proposed assessments.

Financial Hardship and Legal Disability

Appellants contend that OTA should appoint counsel to assist them in this appeal or resolve it by settlement because they are indigent and under legal disability. However, OTA is an administrative agency that lacks the authority or the obligation to appoint a lawyer to assist a

taxpayer with an income tax appeal.⁷ Moreover, OTA lacks authority to make discretionary adjustments to the amount of a tax assessment based on a taxpayer's ability to pay.⁸ (*Appeal of Robinson*, 2018-OTA-059P.) OTA's function in the appeals process is to determine the correct amount of the taxpayer's California income tax liability. (*Ibid.*)

To the extent appellants raise arguments that OTA has not specifically addressed in this opinion, OTA has reviewed such arguments and found them to be without merit.⁹ As discussed above, appellants failed to meet their burden of proving error in FTB's 2002 or 2003 tax year proposed assessments or the federal changes on which each of the assessments are based.

Issue 2: Whether appellants are entitled to abatement of the accuracy-related penalties for the 2002 and 2003 tax years.

R&TC section 19164, which generally incorporates Internal Revenue Code (IRC) section 6662, provides for an accuracy-related penalty of 20 percent of the applicable underpayment.¹⁰

⁷ A taxpayer meeting certain qualifications, such as having an amount in dispute of less than \$30,000, may request assistance from FTB's Tax Appeals Assistance Program. (See <https://www.ftb.ca.gov/help/disagree-or-resolve-an-issue/tax-appeals-assistance-program.html>.) OTA is a separate and distinct agency from FTB and has no involvement in that assistance program.

⁸ In its brief, FTB provided appellants with information on its Offer in Compromise and Installment programs. OTA has no jurisdiction over these programs.

⁹ For instance, OTA does not have jurisdiction on whether appellants are entitled to a remedy for FTB's actual or alleged violation of any substantive or procedural right to due process under the law. (Cal. Code Regs., tit. 18, § 30104.)

Furthermore, appellants' argument that claim preclusion and issue preclusion should bar FTB's proposed assessments is without merit for numerous reasons, including FTB was (1) not a party to, nor in privity with the IRS in, the previous actions against appellants; and (2) the previous actions did not involve appellants' 2002 or 2003 California tax liability.

In addition, OTA also finds that appellants have not established entitlement to additional interest abatement other than what has already been conceded by FTB. Appellants' 2002 and 2003 protests were deferred in 2011 pending the outcome of appellants' appeal with the Ninth Circuit Court of Appeals. Although the Ninth Circuit Court of Appeals affirmed the United States Tax Court's decision on February 14, 2012, appellants did not report this information to FTB. FTB received information that appellants' federal appeal ended when it obtained appellants' IRS master file transcripts, dated May 23, 2018, which showed the February 2014 conclusion of the federal examination. Under FTB's ordinary processes of reviewing deferrals, it admits that deferral should have ended on December 29, 2014. Instead, FTB ended deferral on July 17, 2018. Accordingly, FTB concedes interest from the period of December 29, 2014, through July 16, 2018. No additional interest abatement is warranted.

¹⁰ FTB reduced the accuracy-related penalty for 2002 from 40 percent of the understatement to 20 percent of the understatement. (See *ante*, fn. 1.) As FTB has reduced the penalty to 20 percent, OTA need not address whether the application of R&TC section 19164(a)(1)(B) might have resulted in a 40 percent penalty.

The accuracy-related penalty generally applies to the portion of any underpayment attributable to (1) negligence or disregard of rules and regulations, or (2) any substantial understatement of income tax. (IRC, § 6662(b).)

For individuals, such as appellants, there is a “substantial understatement of income tax” when the amount of the understatement for a tax year exceeds the greater of 10 percent of the tax required to be shown on the return for a taxable year, or \$5,000. (IRC, § 6662(d)(1).) An “understatement” is defined as the excess of the amount of tax required to be shown on the return for the tax year over the amount of the tax imposed that is shown on the return, reduced by any rebate. (IRC, § 6662(d)(2).)

Here, the 2002 proposed assessment is for a total tax of \$481,199.00 and appellants reported tax of \$0.00. The understatement of \$481,199.00 (i.e., \$481,199.00 - \$0.00) exceeds \$48,119.90 (i.e., 10 percent of \$481,199.00, the tax required to be shown on the return), which is greater than \$5,000.00. The 2003 proposed assessment is for a total tax of \$29,146.00 and appellants reported tax of \$0.00. The understatement of \$29,146.00 (i.e., \$29,146.00 - \$0.00) exceeds \$5,000.00, which is greater than \$2,914.60 (i.e., 10 percent of \$29,146.00, the tax required to be shown on the return). Accordingly, FTB properly imposed the 20 percent accuracy-related penalties for the 2002 and 2003 tax years based on substantial understatements of tax.¹¹

The accuracy-related penalties may be reduced or abated if appellants can show (1) there is substantial authority for appellants’ reporting position, (2) the position was adequately disclosed in the tax return (or a statement attached to the return) and there is a reasonable basis for treatment of the item, or (3) they acted in good faith and had reasonable cause for the understatement. (*Appeals of Lovinck Investments N.V., et al.*, 2021-OTA-294P.) Appellants have not established that any of these exceptions apply. Appellants have therefore not shown that the 20 percent accuracy-related penalty for 2002 or 2003 tax years should be abated.

¹¹ OTA also notes the United States Tax Court upheld the accuracy-related penalties under both negligence and substantial understatement. However, OTA need not address negligence since the substantial understatement provision independently applies.

HOLDINGS

1. The proposed assessments of additional tax for the 2002 and 2003 tax years are not barred by the statute of limitations, and appellants have not established error in the proposed assessments of additional tax.
2. Appellants are not entitled to abatement of the accuracy-related penalties for the 2002 and 2003 tax years.

DISPOSITION

In accordance with FTB’s concessions on appeal, the accrued interest on the 2002 and 2003 tax years proposed assessments will be abated for the period December 29, 2014, through July 16, 2018, and the 2002 tax year accuracy related penalty will be reduced from \$192,479.60 to \$96,239.80. FTB’s actions are otherwise sustained.

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 Huy “Mike” Le
 Administrative Law Judge

We concur:

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 Administrative Law Judge

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 Kenneth Gast
 Administrative Law Judge

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