

BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

IN THE MATTER OF THE APPEAL OF,)
)
FMI CORPORATION,) OTA NO. 220510490
)
 APPELLANT.)
)
)

TRANSCRIPT OF ELECTRONIC PROCEEDINGS

State of California

Wednesday, July 19, 2023

Reported by:
ERNALYN M. ALONZO
HEARING REPORTER

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Transcript of Electronic Proceedings,
taken in the State of California, commencing
at 11:16 a.m. and concluding at 11:36 a.m. on
Wednesday, July 19, 2023, reported by Ernalyn M.
Alonzo, Hearing Reporter, in and for the State
of California.

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APPEARANCES:

Panel Lead: ALJ SARA HOSEY

Panel Members: ALJ KENNY GAST
ALJ LAUREN KATAGIHARA

For the Appellant: RICK NAJJAR

For the Respondent: STATE OF CALIFORNIA
FRANCHISE TAX BOARD
CHRISTOPHER COOK
ERIC YADAO

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I N D E X

E X H I B I T S

(Appellant's Exhibits 1-5 were received at page 7.)
(Department's Exhibits A-M were received at page 7.)

P R E S E N T A T I O N

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By Mr. Najjar	7
By Mr. Cook	14

C L O S I N G S T A T E M E N T

	<u>P A G E</u>
By Mr. Najjar	6

1 California; Wednesday, July 19, 2023

2 11:16 a.m.

3
4 JUDGE HOSEY: We are now on the record.

5 This is the Appeal of FMI Corporation, OTA Case
6 Number 220510490. Today it's 11:16 a.m. on July 19th,
7 2023. This appeal is being conducted electronically lead
8 by myself Judge Hosey via Webex.

9 With me today are Judge Lauren Katagihara and
10 Judge Kenneth Gast. I'm the lead judge for the purpose of
11 conducting this hearing today, but all three judges on the
12 panel are co-equal decision makers.

13 I want to remind today's participants and viewers
14 that the Office of Tax Appeals is not a court, but an
15 independent appeals body. The office is staffed by tax
16 experts and is independent of the State's tax agencies.
17 OTA does not engage in any ex parte communications with
18 either party.

19 Our decision will be based on the arguments and
20 evidence provided by the parties on appeal in conjunction
21 with an appropriate application of the law. The Panel has
22 read the briefs and examined the submitted exhibits, and
23 we're looking forward to your arguments today.

24 Can I have the parties' representatives introduce
25 themselves please, starting with the Appellant.

1 MR. NAJJAR: Rick Najjar for this LLP.

2 JUDGE HOSEY: Thank you.

3 And Respondent.

4 MR. COOK: This is Chris Cook Tax Counsel with
5 the Franchise Tax Board.

6 MR. MURADYAN: This is David Muradyan with the
7 Franchise Tax Board as well.

8 JUDGE HOSEY: Thank you. The issue identified on
9 appeal is whether Appellant has established reasonable
10 cause to abate the delinquent penalties and late-filing
11 penalties imposed on tax years 2014 through 2018.

12 Does this properly reflect your understanding of
13 the issue, Mr. Najjar?

14 MR. NAJJAR: That properly reflects my
15 understanding, Your Honor.

16 JUDGE HOSEY: Thank you.

17 And Mr. Cook?

18 MR. COOK: Yes, Judge Hosey. That's the issue.

19 JUDGE HOSEY: Great. Thank you.

20 As for our exhibits today, Appellant submitted
21 Exhibits 1 through 5, and Respondent submitted Exhibits A
22 through M. No objections were made to the exhibits.
23 Therefore, Exhibits 1 through 5 and A through M are hereby
24 admitted as evidence into the Record.

25 ///

(Appellant's Exhibits 1-5 were received
in evidence by the Administrative Law Judge.)

(Department's Exhibits A-M were received in evidence by the Administrative Law Judge.)

JUDGE HOSEY: Let's move forward with the parties' presentations. We'll begin with Mr. Najjar.

You have 15 minutes when ready.

PRESENTATION

MR. NAJJAR: Sure. And thank you for the OTA for hearing our case today.

So I'll just start with a factual overview of what happened. FMI Corporation is an S corporation legally incorporated in North Carolina. It provides investment banking type services and consulting services primarily to the construction industry. Throughout my presentation I'll just refer to FMI as Appellant.

So Appellant in 2005 contemplated in actually opening up a physical office and making an investment in the State of California. So naturally in anticipation of getting ready to open up this office, they registered to do business with the Secretary of State. They didn't register with any other California agency and definitely not the taxing agency.

There was no other visits to California. No

1 other investment in California. Nothing to do with the
2 physical location. The plans to open the physical office
3 were totally abandoned. However, the registration with
4 the Secretary of State was still out there. Despite
5 Appellant's best efforts, it didn't successfully withdraw
6 the registration. So that has stayed on the Secretary of
7 State's records.

8 The next thing I want to point out is from 2005
9 to 2020 Appellant did not file an income or franchise tax
10 return with the California FTB. And to also note they
11 were not physically present in California, but from 2011
12 on they exceeded the factor presence threshold that was
13 enacted in 2011 under Section 23101. Given the
14 constitutional law at the time and the precedent set by
15 Quill v North Dakota, the Appellant believed that a
16 physical presence was still necessary for California to
17 impose any other tax law, not just sales and use tax, but
18 any tax. And I'll get back to that in a little bit.

19 However, as we all know after Wayfair v South
20 Dakota was decided in June 2018, shortly thereafter the
21 Appellant decided to reevaluate their potential tax
22 exposure across several states, including California.
23 Because California had passed the factor presence nexus
24 test in 2011, under Section 23101 of the Revenue &
25 Taxation Code, Appellant, after internal deliberations and

1 consultations with outside tax advisers, believed that it
2 would be best to file past tax returns.

3 And, you know, essentially Appellant believed
4 that the Wayfair case validated any constitutional
5 concerns or ameliorate any constitutional concerns when it
6 came to Section 23101. Appellant would have liked to
7 enter into the FTB's voluntary disclosure program, but was
8 not able to do so given the registration that was still on
9 the Secretary of State's records. So if you're registered
10 with the Secretary of State, the FTB does not allow you to
11 enter into its voluntary disclosure program.

12 Nonetheless, Appellant filed the necessary
13 returns for 2014 through 2018 on June 26, 2020, along with
14 the proper payments. And you can see that in the FTB's
15 Exhibits A through F. The FTB, after examining these
16 returns, assessed the late-filing penalty and a delinquent
17 penalty for each period. And you can see that with
18 Exhibits H through L of the FTB's exhibits. And there was
19 applicable interest. Appellant paid these amounts in full
20 and then subsequently requested a refund on the basis that
21 there was reasonable cause to waive these penalties to
22 begin with. The FTB subsequently denied the refund based
23 on finding that there was no reasonable cause.

24 So just to give an overview of our argument, when
25 Appellant was looking at opening an office in 2005, they

1 were simply relying on state tax publications and what the
2 state law was in California at that time, which to the
3 best of the Appellant's understanding was that a physical
4 presence was necessary to file an income tax return.
5 After they would open up the office, they planned on
6 filing an income tax return. But until that time, until
7 physical presence was generated, it's their position and
8 it was clear in California guidance that without a
9 physical presence there would never be a filing
10 requirement, even despite registering with an agency like
11 the California Secretary of State.

12 Post 2011, we realized the FTB's -- Appellant
13 realized the FTB's position is 23101 applies, and that
14 physical presence is no longer required and we --
15 Appellant also recognizes that in California FTB Technical
16 Advice Memorandum Number 2012-01 published on
17 November 29th, 2012. This guidance discusses that Quill
18 is definitely not applicable to income and franchise
19 taxes, and that the factor presence nexus threshold
20 applies.

21 Nonetheless, the FTB and the legislature cannot
22 decide a federal constitutional issue. So what this means
23 for reasonable cause is that while ignorance of the law
24 itself is not reasonable cause, a good-faith effort to
25 comply with the law and understanding that novel issues

1 exist at the time can be considered reasonable cause. So
2 this -- it's Appellant's position that this is a novel
3 issue because even though California guidance came out and
4 said we no longer follow Quill or require physical
5 presence or believe physical presence is required for
6 income tax filing, it was still up in the air from a
7 constitutional perspective until Wayfair was decided in
8 June of 2018.

9 When evaluating whether or not this is a novel
10 position, it doesn't matter if the position is ultimately
11 right or wrong, which I think we can all agree that it was
12 probably not correct that a physical presence was required
13 for income tax. But there's definitely -- there
14 definitely was as a tremendous amount of debate before
15 2018. You can look at any academic journal law reviews or
16 business journals, et cetera, et cetera, and find that
17 there was a tremendous difference of opinion.

18 Any major tax advisory firm would also say that
19 there is a difference of opinion and there is risk, but
20 it's definitely a reasonable position to take that a
21 physical presence would be required prior to 2018.
22 Circling back to reasonable cause if it's a novel position
23 that that's established, there are several cases in the
24 federal realm which have done a very good job of refining
25 what reasonable cause means. For instance, Williams v

1 Commissioner in 2004, and they stated where a case is one
2 of first impression with no clear authority to guide the
3 decision makers. That's the major and complex issue and
4 the negligence penalty is inappropriate. I think that
5 sums it up all here.

6 Again, I recognize -- the Appellant recognizes
7 that California did publish guidance in 2012 saying this
8 is what we're going to do now. But again, this is a
9 constitutional issue, and it is still reasonable given
10 that it's not a fringed theory that the taxpayer was
11 subscribing to but one that's quite widespread. Moreover,
12 we're not asking for forgiveness of the tax, just the
13 penalties. In the sales and use tax realm, once many
14 states put in their factor presence test or economic nexus
15 threshold after Wayfair, they weren't going to collect
16 back taxes, interest, and penalties from that rule, even
17 though the Supreme Court came and said for sales tax Quill
18 is wrong.

19 But in closing we just believe that this is a
20 reasonable position to take for the tax years at issue.
21 The taxpayer was aware that there could be filing
22 obligations for those years at issue but just did not
23 subscribe to -- did not acquiesce to states that were
24 putting in factor presence nexus standards like California
25 and a few others at that time.

1 Thank you.

2 JUDGE HOSEY: Thank you, Mr. Najjar.

3 I'm going to go ahead and see if the Panel has
4 any questions for you before we move forward with the
5 Franchise Tax Board's presentation.

6 Judge Katagihara, any questions for Appellant?

7 JUDGE KATAGIHARA: No questions for Appellant.
8 Thank you.

9 JUDGE HOSEY: Thank you.

10 Judge Gast, any questions for Appellant?

11 JUDGE GAST: This is Judge Gast. I have one
12 question for Appellant. You said that the company was
13 registered with the California Secretary of State in 2005
14 and forward. And if so, how does that fit into your
15 reasonable cause argument?

16 MR. NAJJAR: Sorry, Judge Gast. The taxpayer did
17 register with the Secretary of State in 2005. But after
18 it abandoned plans to open the office, did its best to
19 withdraw from the Secretary of State given it would have
20 nothing to do -- or what it believed nothing to do with
21 California at the time.

22 With that also in mind, especially at that time,
23 they still believed, like, if there's no physical
24 presence, there's not going to be a tax filing obligation.
25 So despite registrations under the Quill standard, that's

1 still -- that still was not enough to generate a filing
2 requirement for taxes.

3 JUDGE GAST: Okay. Thank you. That's all the
4 questions I have.

5 JUDGE HOSEY: This is Judge Hosey. Thank you,
6 Mr. Najjar.

7 We'll go ahead and move to Respondent's arguments
8 presentation.

9 Mr. Cook, are you ready to begin?

10 MR. COOK: Yes, Judge Hosey. Thank you.

11 JUDGE HOSEY: You have 15 minutes. Thank you.

12

13 PRESENTATION

14 MR. COOK: There is no dispute that Appellant
15 filed each tax return for tax years 2014 through 2018
16 late. And what's not at issue in this case is whether or
17 not Appellant made a good-faith effort to come into
18 compliance after it realized it was supposed to file
19 California tax returns for those years. The only issue in
20 this case is whether reasonable cause exist to abate the
21 penalties that were assessed because those returns were
22 filed late.

23 The well-established legal standard for finding
24 that reasonable cause exists requires Appellant to provide
25 evidence showing that an ordinarily intelligent and

1 prudent business person would have acted similarly under
2 the same circumstances. It is also a well-established
3 precedent that it is not reasonable cause when a taxpayer
4 did not know it had a filing requirement. In this case,
5 Appellant is arguing that it just decided not to file a
6 return, and there's no, you know, reasonable cause basis
7 for that either.

8 Supporting cases for the established precedence
9 are not only found in FTB's opening brief, it can also be
10 found in Board of Equalization decisions in Appeal of Jane
11 Morris and Leila G. Forbes and Appeal of Diebold
12 Incorporated. So Appellant's claim for reasonable cause
13 is not supported by well-established law. You know, in
14 the briefing Appellant argued that it wasn't even aware it
15 had to file returns for these years. And so it's a new
16 argument in this presentation that they did know, but they
17 just decided not to.

18 If there is, you know, reasonable cause to be
19 shown in this case, it would probably be in the realm of
20 professional advice. And we don't have any evidence so
21 far of any advice given to Appellants or any documentation
22 of their decision making for the years at issue when the
23 returns were supposed to be filed. Since there is no
24 evidence that ordinary care and prudence was exercised
25 concerning the tax returns for any years in this case, FTB

1 asks the OTA to sustain the penalties assessed for
2 Appellant filing its returns rate.

3 Thank you, and I'm happy to answer any questions.

4 JUDGE HOSEY: Thank you, Mr. Cook.

5 Let me turn to my Panel and see if we have any
6 questions for you.

7 Judge Katagihara?

8 JUDGE KATAGIHARA: This is Judge Katagihara.

9 Still no questions. Thank you.

10 JUDGE HOSEY: Judge Gast?

11 JUDGE GAST: This is Judge Gast. No questions.

12 Thanks.

13 JUDGE HOSEY: This is Judge Hosey again. I don't
14 have any questions for you at this time either. So I'm
15 going to go ahead and move forward.

16 Mr. Najjar, you have five minutes to respond to
17 the Franchise Tax Board or to make any final comments
18 before we end for today. You may begin when you're ready.

19 MR. NAJJAR: Sure, Judge Hosey.

20

21 CLOSING STATEMENT

22 MR. NAJJAR: Just to clarify, the taxpayer --
23 when we say the taxpayer wasn't aware of their filing
24 requirement, they weren't aware of the filing retirement
25 given that -- with the physical presence rule. So they

1 didn't -- if there wasn't a physical presence in
2 California in those years, they weren't aware that there
3 would be something to file because it's not showing up in
4 their data, per se.

5 And also in the realm of professional advice, I
6 would wholeheartedly agree with the FTB that that is
7 generally the case if we're looking at something that's
8 nuanced in California statutes or regs that are very
9 specific to this case -- you know, a case. But when
10 something is widespread and so practiced for 30 years,
11 well, more closer to five decades if you go back to
12 National Bellas Hess, this is just industry-wide practice.
13 It's been known. Every single tax adviser that Appellant
14 could have approached would have provided the same answer.
15 So I think, you know, an exception to having documented
16 professional advice in like a tax technical memorandum
17 would be if something is just so widespread and so widely
18 known in a specific area of law that -- and, you know,
19 Quill, Wayfair that's what it effects.

20 Also, establishing again what is well established
21 law on reasonable cause in California, it doesn't -- it
22 does address, again, that ignorance of the law is not
23 enough, but there is that exception that if the position
24 is taken as reasonable. We understand -- or the Appellant
25 understands that that position with Quill turned out to be

1 wrong years later. And there was risk out there but it's
2 not -- the question isn't if the position was right, it's
3 if it was reasonable. So if someone working with
4 Appellant would have said, yeah, this is a reasonable
5 position to take.

6 Thank you. That's all I have.

7 JUDGE HOSEY: Thank you, Mr. Najjar.

8 This is Judge Hosey again. I'm going to see if
9 we have any final questions from the Panel.

10 Judge Katagihara, any further questions for the
11 participants today?

12 JUDGE KATAGIHARA: This is Judge Katagihara. No
13 questions. Thank you.

14 JUDGE HOSEY: Judge Gast, any questions?

15 JUDGE GAST: This is Judge Gast. No further
16 questions. Thank you.

17 JUDGE HOSEY: Thank you.

18 This is Judge Hosey again. I think we're ready
19 to conclude the hearing. Evidence has been admitted into
20 the record, and we have the arguments from your briefs as
21 well as your oral argument presented today. We now have a
22 complete record from which to base our opinion.

23 I wish again to thank both parties for their
24 efforts in this matter. This concludes the hearing for
25 this appeal. The parties should expect our written

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opinion no later than 100 days from today.

With that we are now off the record.

(Proceedings adjourned at 11:36 a.m.)

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HEARING REPORTER'S CERTIFICATE

I, Ernalyne M. Alonzo, Hearing Reporter in and for
the State of California, do hereby certify:

That the foregoing transcript of proceedings was
taken before me at the time and place set forth, that the
testimony and proceedings were reported stenographically
by me and later transcribed by computer-aided
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foregoing is a true record of the testimony and
proceedings taken at that time.

I further certify that I am in no way interested
in the outcome of said action.

I have hereunto subscribed my name this 25th day
of July, 2023.

ERNALYN M. ALONZO
HEARING REPORTER