OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Consolidated Appeals of: **KRITON CORPORATION,** **J. VAKILIAN AND** **F. VAKILIAN**	OTA Case Nos. 20046093, 21037402

OPINION

Representing the Parties:

For Appellants:	Michael Dallo, Attorney Kevin Waldron, Attorney
For Respondent:	D'Arcy Dewey, Tax Counsel III Jason Riley, Tax Counsel IV Bradley Kragel, Tax Counsel IV
For the Office of Tax Appeals:	Grant S. Thompson, Tax Counsel V

O. AKOPCHIKYAN, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, appellant Kriton Corporation (Kriton) appeals actions by respondent Franchise Tax Board (FTB) proposing additional tax of $32,265.00 and $36,897.00 for the 2012 and 2013 tax years, respectively, plus applicable interest. Appellants J. Vakilian (Mr. Vakilian) and F. Vakilian (Mrs. Vakilian) (together, the Vakilians) appeal FTB's actions proposing additional tax of $343,104.00, an accuracy-related penalty of $68,620.80, and applicable interest, for the 2013 tax year.[1]

Office of Tax Appeals (OTA) Administrative Law Judges Tommy Leung, Andrea L.H. Long, and Ovsep Akopchikyan held an electronic oral hearing for this matter on March 24, 2023. At the conclusion of the hearing, the record was closed and this matter was submitted for an opinion.

[1] During the appeal, FTB allowed the Vakilians additional tax basis in their Kriton stock and made other adjustments that reduced the proposed assessments against the Vakilians for the 2013 tax year to additional tax of $220,409.00 and an accuracy-related penalty of $44,081.80, plus applicable interest.

ISSUES

1. Whether FTB erred in disallowing Kriton's business expense deductions for officer compensation in the amounts of $200,000 and $370,000 for the 2012 and 2013 tax years, respectively.
2. Whether the Vakilians have established a basis to abate the accuracy-related penalty.

FACTUAL FINDINGS

1. The Vakilians, California residents, formed Kriton, a C corporation, in 2003 to operate a gas station and convenience store in California. Mr. and Mrs. Vakilian each owned 50 percent of Kriton.
2. On February 13, 2012, Kriton sold its assets to a third party for a total sales price of $5.1 million. As part of the consideration, the buyer issued two promissory notes to Kriton totaling $3.4 million. Both promissory notes called for monthly installment payments until March 1, 2015, when the unpaid balance was due in full.
3. The buyer paid off both promissory notes early around June 2013. Kriton dissolved in December 2013.
4. After Kriton sold its assets, Kriton paid $100,000 to each of the Vakilians at the end of 2012 (for a total of $200,000) and $185,000 to each of the Vakilians at the end of 2013 (for a total of $370,000). Kriton deducted these amounts as officer compensation on its 2012 and 2013 California corporate franchise tax returns. The Vakilians reported these amounts as taxable W-2 wages on their personal income tax returns.
5. FTB examined Kriton's 2012 and 2013 California tax returns and the Vakilians' joint 2013 California tax return.
6. FTB determined that Kriton's officer compensation to the Vakilians in the amounts of $200,000 and $370,000 for the 2012 and 2013 tax years, respectively, constituted distributions of earnings and not deductible compensation as reported on Kriton's returns.
7. FTB also (1) determined that the Vakilians failed to report capital gain on the liquidating distributions from Kriton on their joint 2013 California tax return and (2) reclassified the $370,000 of W-2 wages in 2013 as a liquidating distribution.
8. FTB issued Notices of Proposed Assessments and Notices of Action to Kriton and the Vakilians sustaining these adjustments.

9. Kriton and the Vakilians timely filed these appeals, which OTA consolidated after considering FTB's request for consolidation.

DISCUSSION

Issue 1: Whether FTB erred in disallowing Kriton's business expense deductions for officer compensation in the amounts of $200,000 and $370,000 for the 2012 and 2013 tax years, respectively.

Deductions are a matter of legislative grace, and a taxpayer who claims a deduction has the burden of proving by competent evidence entitlement to that deduction. (*Appeal of Vardell*, 2020-OTA-190P.) Unsupported assertions are not enough to satisfy the taxpayer's burden of proof. (*Appeal of Dandridge*, 2019-OTA-458P.)

Internal Revenue Code (IRC) section 162(a)(1) generally allows a deduction for ordinary and necessary business expenses, including "a reasonable allowance for salaries or other compensation for personal services actually rendered." (See R&TC, § 24343 [generally conforming to IRC section 162].) The payment of dividends to shareholders, however, is not deductible. (*O.S.C. & Assocs. v. Commissioner* (9th Cir. 1999) 187 F.3d 1116, 1119.) When payments are made to an individual who is both a corporate employee and a principal shareholder, a two-prong test is applied to determine whether the distribution is truly compensatory. (*Id*. at pp. 1119-20.)

The two-prong test asks whether the payment is in fact made for services rendered (the intent prong) and whether the amount of the payment is reasonable in relation to the services performed (the amount prong). (Treas. Reg. § 1.162-7(a); *O.S.C. & Assocs. v. Commissioner*, *supra*, 187 F.3d at p. 1120.) "The existence of a compensatory purpose can often be inferred if the amount of the compensation is determined to be reasonable." (*O.S.C. & Assocs. v. Commissioner*, *supra*, at p. 1120, citation omitted.) However, "[i]n the rare case where there is evidence that an otherwise reasonable compensation payment contains a disguised dividend, the inquiry may expand into compensatory intent apart from reasonableness." (*Id*. at p. 1118, citation omitted.)

At the oral hearing in this matter, Kriton's and the Vakilians' tax preparer, Mr. Starkey, testified that (1) he met the Vakilians in late 2012 and determined that the sale of their business "was going to result in a large amount of tax"; (2) he looked at the transaction in "different ways

. . . so that [he] could save [the Vakilians] the most amount of money"; (3) he decided to "keep the corporation open … [and] put both Mr. and Mrs. Vakilian on payroll so that they can draw salaries from it"; (4) he put them on payroll "to lessen the amount of income that was coming in from the installment sale payments so [he] could reduce the tax"; (5) he "put them on payroll to lessen the capital gains rate, although they did pay payroll taxes on it"; (6) "in [his] own mind [he] had a plan to help the Vakilians save some tax money"; and (7) he told FTB on audit that the only way to take money out of a corporation is through payroll, loan repayment, or dividends.

Mr. Starkey's testimony establishes that he caused Kriton to pay the purported officer compensation to the Vakilians in 2012 and 2013 primarily for tax savings, and not as compensation for services they in fact rendered. This conclusion is supported by the fact that Mr. and Mrs. Vakilian each received the same amount of compensation for both years, which corresponds to their ownership interest in Kriton and not to the different services they each performed after selling the business. A direct proportional relationship between stock ownership and compensation is considered a very strong indication of a disguised dividend. (See *Nor-Cal Adjusters v. Commissioner* (9th Cir. 1974) 503 F.2d 359, 361; *O.S.C. & Assocs., Inc. v. Commissioner*, *supra*, 187 F.3d 1116.)

This conclusion is further supported by the fact that the Vakilians did not establish what services they performed in 2013 to earn $370,000 in W-2 wages—the highest wages Kriton ever paid the Vakilians since formation. Based on Mrs. Vakilian's testimony, the Vakilians did not provide any training or other services to the buyer in 2013. Because the Vakilians failed to establish what they did to earn $370,000 of W-2 wages in 2013, the 2013 officer compensation fails both the intent and amount prongs.

By contrast, notwithstanding Mr. Starkey's statements regarding his intent in causing Kriton to pay officer compensation, a portion of the 2012 compensation may satisfy both the intent and amount prongs. Mrs. Vakilian credibly testified that, after selling the business in February 2012, the Vakilians helped train the buyer and operate the business for six to eight months. The Vakilians presumably assisted the buyer to ensure that the business remained profitable, which in turn increased the likelihood that the buyer fully paid the $3.4 million in promissory notes. However, Kriton and the Vakilians have not established what portion of the 2012 compensation was for services performed and what portion was a disguised dividend. (See Treas. Reg. § 1.162-7(b)(1) [only the amount of compensation determined to be excessive under

the intent prong is a disguised dividend, and the remaining amount is deductible]; see *Leonard Pipeline Contractors, Ltd. v. Commissioner* (9th Cir. 1998) 142 F.3d 1133, 1135-36 [taxpayer has the burden of proving that the tax agency's determination regarding the amount of reasonable compensation was wrong].) This panel will not endeavor to estimate what portion of the officer compensation for the 2012 tax year represents reasonable compensation. (See *Id*. at p. 1136 ["It is not our task to put the factors together . . . and come up with what is reasonable compensation"].)

Accordingly, FTB did not err in disallowing Kriton's business expense deductions for officer compensation in the amounts of $200,000 and $370,000 for the 2012 and 2013 tax years, respectively.

Issue 2: Whether the Vakilians have established a basis to abate the accuracy-related penalty.

R&TC section 19164, which generally incorporates the provisions of IRC section 6662, imposes a 20 percent accuracy-related penalty on an underpayment attributable to a substantial understatement of income tax. For individual taxpayers, an understatement is substantial if it exceeds the greater of $5,000 or 10 percent of the tax required to be shown on the return. (IRC, § 6662(d)(1)(A).) As relevant here, the penalty does not apply to any portion of an underpayment if it is shown that there was reasonable cause for the underpayment and the taxpayer acted in good faith with respect to that portion of the underpayment. (R&TC, § 19164(d)(1); IRC, § 6664(c)(1).)

FTB determined that the Vakilians are liable for an accuracy-related penalty for the 2013 tax year because they failed to report capital gain on the liquidating distributions from Kriton on their 2013 personal tax return, and this failure resulted in a substantial understatement of tax.[2]

The Vakilians contend that the accuracy-related penalty should not be imposed because they had reasonable cause for the underpayment and acted in good faith. They contend that (1) this case involves "a complex issue regarding the gain generated on a liquidating distribution of a C corporation via the sale of its assets on an installment sale basis"; (2) the Vakilians did not

[2] As noted previously, FTB made adjustments on appeal in favor of the Vakilians, which reduced the additional tax to $220,409.00 and the accuracy-related penalty to $44,081.80, plus applicable interest. Even after these adjustments, the additional tax remaining ($220,409.00) is greater than both $5,000.00 and 10 percent of the tax required to be shown on the return ($25,001.60). (The tax required to be shown on the return is $250,016.00, which is the sum of FTB's tax assessment of $220,409.00 and the Vakilians' reported tax of $29,607.00. Ten percent of that sum is $25,001.60.)

have the "knowledge base" to analyze this correctly because they do not know "the taxation principles of installment sales, amount realized, basis, gain recognized, liquidating distributions of cash, and double taxation of C corporations"; and (3) the Vakilians recognized their lack of knowledge and hired "the services of a tax professional, who still was unable to accurately characterize the transaction."

Whether or not a taxpayer acted with reasonable cause and in good faith depends upon all the pertinent facts and circumstances. (Treas. Reg. § 1.6664-4(b)(1).) At the oral hearing in this matter, Mr. Starkey testified that he was competent to advise the Vakilians because he was licensed as an enrolled agent in 1988; has "far exceeded the continuing education requirement" every year since; employs three other enrolled agents and has "a tax attorney on staff"; does bookkeeping, payroll, insurance, and securities for "as many as 3,100 clients"; and is experienced with different entity forms and "very familiar" with FTB and IRS audits. Mr. Starkey also testified that he explained to the Vakilians that they did not owe personal income tax from the sale of the business because the buyer paid Kriton, not the Vakilians. He testified that the Vakilians "didn't get anything for the stock." Thus, he advised that "all they had to do in 2013 was pay almost a half-million dollars in corporate tax."

Mrs. Vakilian testified that Mr. Starkey "was highly recommended from [the Vakilians'] previous tax preparer, Mr. Stevens," and that they met Mr. Starkey and "felt very comfortable" with him. She testified that although she was the chief financial officer of Kriton, her background and training is as a nurse in mental health. She left nursing to open a computer repair business as a small sole proprietorship with Mr. Vakilian, which they ended in 2003 to operate the gas station through Kriton, the first corporation they formed.

Mrs. Vakilian testified that she asked Mr. Starkey "to close the corporation" and give "the advice that was needed to do everything correctly" after the buyer fully paid the promissory notes earlier than anticipated. She testified that she "provided [Mr. Starkey] with all the documents that we had." She also testified that she reviewed the returns, she believed all the major income items were on the return, she believed the corporate and personal returns were "totally different," and she did not expect the installment payments to appear on their personal return because the buyer was paying Kriton and not the Vakilians in their personal capacity. Mrs. Vakilian testified that Mr. Starkey "told us we have no personal liabilities. We always believed that because, you know, we paid so many taxes."

The tone, behavior, and overall demeanor of Mrs. Vakilian and Mr. Starkey supports the conclusion that their testimonies were sincere, credible, and consistent with the record as a whole. However, reasonable cause is lacking here. As noted above, Mr. Starkey's testimony establishes that he caused Kriton to pay officer compensation in 2012 and 2013 primarily for tax savings—including $370,000 of purported W-2 wages in 2013 when the business was closed. Although Mrs. Vakilian does not have specialized training in tax, she was the chief financial officer of Kriton for approximately 10 years and helped successfully operate a gas station that had, in her own words, "so many rules and regulations." She was therefore sophisticated enough to have questioned Mr. Starkey's competence after he recommended that Kriton pay $370,000 of purported W-2 wages—the highest amount Kriton ever paid the Vakilians—for 2013. Mrs. Vakilian knew that she and Mr. Vakilian did not provide any services to the buyer in 2013 to justify the 2013 compensation. She also knew, or should have known, that any services she performed related to winding down Kriton did not justify receiving the highest amount of W-2 wages from Kriton since formation. Therefore, the Vakilians were not reasonable in relying on Mr. Starkey's tax advice related to the sale of their business, as Mr. Starkey's tax advice demonstrated that he was motivated by tax savings and not the proper application of tax law.

Accordingly, the Vakilians have not established a basis to abate the accuracy-related penalty for the 2013 tax year.

HOLDINGS

1. FTB did not err in disallowing Kriton's business expense deductions for officer compensation in the amounts of $200,000 and $370,000 for the 2012 and 2013 tax years, respectively.
2. The Vakilians have not established a basis to abate the accuracy-related penalty.

DISPOSITION

FTB's actions, as modified by FTB on appeal, are sustained.[3]

DocuSigned by:
Ovsep Akopchikyan
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Ovsep Akopchikyan
Administrative Law Judge

We concur:

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Andrea LH Long
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Andrea L.H. Long
Administrative Law Judge

DocuSigned by:
Tommy Leung
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Tommy Leung
Administrative Law Judge

Date Issued: 6/29/2023

[3] As noted previously, on appeal, FTB reduced the proposed tax assessment against the Vakilians for the 2013 tax year to $220,409.00 and the accuracy-related penalty to $44,081.80, plus applicable interest.